

# **RULES OF ORIGIN AS INTERNATIONAL TRADE HINDRANCES**

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## **ABSTRACT**

This paper talks about the usage of RoO as protectionist apparatuses in different regional trade areas, as the NAFTA, the AGOA and the SADC, and the usage of RoO as trade-diverting tools. In addition, the paper talks about the spaghetti-bowl phenomenon, with an emphasis on the APEC region, and clarifies how to achieve a proper harmonization of both non-preferential and preferential RoO as a solution to overcome the previously mentioned odds facing international trade. Moreover, the paper suggests the adoption of more solutions as well at the end of each part.

By harmonizing both preferential and non-preferential RoO in the way explained in the paper, all WTO member states would be stopped from using RoO as concealed commercial policy and protectionist tools, and would be stopped from designing stringent, trade-diverting RoO. Furthermore, the variation in RoO along with their worldwide propagation would be eliminated; exporters and producers would not have to worry anymore about complying with different RoO imposed by different countries and RTAs all over the world, which would consequently lead to the abatement of the high administrative costs traders face.

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## LIST OF ABBREVIATIONS

AD	Anti-dumping
AGOA	African Growth Opportunity Act
APEC	Asia-Pacific Economic Cooperation
APTA	Asia-Pacific Trade Agreement
ARoO	Agreement on Rules of Origin
ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textiles and Clothing
CARICOM	Caribbean Community
CBERA	Caribbean Basin Economic Recovery Act
CBI	Caribbean Basin Initiative
CBTPA	Caribbean Basin Trade Partnership Act
CCC	Customs Cooperation Council
CIF	Cost Insurance and Freight
CRO	Committee on Rules of Origin
CTC	Change in Tariff Classification
CTCh	Change in Tariff Chapter
CTH	Change in Tariff Heading
CTI	Change in Tariff Item
CTSH	Change in Tariff Sub-heading
CU	Customs Union
CV	Countervailing
DR-CAFTA	Dominican Republic – Central America Free Trade Agreement
DSB	Dispute Settlement Body
EBA	Everything but Arms
EC	European Community
EU	European Union
EUCU	European Union Customs Union
FOB	Free on Board
FTA	Free Trade Agreement
FTAA	Free Trade Area of the Americas
FTAAP	Free Trade Area of the Asia-Pacific

GATT	General Agreement on Tariffs and Trade
GSP	Generalized System of Preferences
HS	Harmonized Commodity Description and Coding System
HWP	Harmonization Work Program
ICC	International Chamber of Commerce
LDCs	Least Developing Countries
LDBCs	Lesser Developed Beneficiary Countries
MFN	Most-Favored-Nation
NAFTA	North American Free Trade Agreement
PSRoO	Product-specific Rules of Origin
RoO	Rules of Origin
RTA	Regional Trade Agreement
RVC	Regional Value Content
SAARC	South Asian Association for Regional Cooperation
SACU	South African Customs Union
SADC	South African Development Community
SG&A	Selling, General, and Administrative Expenses
TCRO	Technical Committee on Rules of Origin
UAW	United Auto Workers
UK	United Kingdom
U.S.	United States
VA	Value Added
VC	Value Content
WCO	World Customs Organization
WTO	World Trade Organization

## I. INTRODUCTION

Like a widespread epidemic that brings fear and disturbs life on earth, stringent RoO along with their complexity and worldwide diversity bring fear to traders, disturb them and hinder international trade.

There are two types of RoO: preferential and non-preferential. Unfortunately, both types can be used as international trade obstacles.<sup>1</sup> Preferential RoO are used to stipulate whether a good is deemed to originate in a RTA partner country (as in a FTA or a CU) or a preference-granted one (as in a GSP) and consequently, eligible for preferential treatment.<sup>2</sup> Non-preferential RoO are used for other well-known objectives, including: gathering trade statistics, government procurement, carrying out origin marking and labeling requirements and the application of trade policy instruments as AD duties, CV measures and quantitative restrictions.<sup>3</sup> In general, the establishment of the many preferential contractual<sup>4</sup> and/or autonomous<sup>5</sup> trade regimes, the intensification in use of using trade policy instruments, and lowering MFN tariffs are the three main motives that augment the part of RoO.<sup>6</sup>

About 421 RTAs were reported to the WTO as of December 2008.<sup>7</sup> As a result of establishing those RTAs, trade barriers have been reduced or eliminated.<sup>8</sup> Consequently, countries started to use RoO as alternative barriers to trade by making them too stringent. The level of such stringency could vary

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<sup>1</sup> Joseph A. LaNasa III, *An Evaluation of the Uses and Importance of Rules of Origin and the Effectiveness of the Uruguay Round's Agreement on Rules of Origin in Harmonizing and Regulating Them* 3 (Harvard L. Sch., The Jean Monnet Working Papers Series No. 9601, 1996).

<sup>2</sup> Final Act Embodying the Results of the Uruguay Round of Multilateral Trade Negotiations, Apr. 15, 1994, 1868 U.N.T.S. 397 (1994), available at [http://www.wto.org/english/docs\\_e/legal\\_e/22-roo.pdf](http://www.wto.org/english/docs_e/legal_e/22-roo.pdf) [hereinafter Agreement on Rules of Origin].

<sup>3</sup>*Id.* at Art I.

<sup>4</sup> Contractual preferential trade regimes are also known as bilateral or reciprocal trade regimes.

<sup>5</sup> Autonomous preferential trade regimes are also known as unilateral or non-reciprocal trade regimes.

<sup>6</sup> Edwin Vermulst, Keynote Speech for the ADB Intensive Course on Rules of Origin, Intensive Course on Rules of Origin 2-4 (Sept. 6, 2004) (transcript is available at <http://www.adb.org/Documents/Events/2004/Intensive-Rules-Origin/text-vermulst.pdf>).

<sup>7</sup> World Trade Organization, [http://www.wto.org/english/tratop\\_e/region\\_e/region\\_e.htm](http://www.wto.org/english/tratop_e/region_e/region_e.htm) (last visited May 17, 2010).

<sup>8</sup> Reducing trade barriers does not only happen in that case since it can take place as well when a country decides to lower its MFN tariff on a certain good or goods, regardless of its engagement to any RTA.

from one RTA to another according to the interest of their constituent parties. Using RoO as replacement barriers to trade is called as the “Law of Constant Protection” by Bhagwati.<sup>9</sup>

In 1995, 138 AD and CV duties were reported to the WTO. In 2000, the number of AD and CV duties reported to the WTO became 250. In 2003, the number increased to 220.<sup>10</sup> In 2008, specifically from the period between January and June, the number of introduced AD inspections (eighty-five) was thirty-nine percent higher than that of the parallel period of 2007 (sixty-one).<sup>11</sup> Since such AD duties are imposed against products that originate in a certain country, the importing country therefore, is obligated to make holdings concerning the origin of the product. In addition, many circumvention issues have been solved by using RoO. Thereupon, the part of RoO increased and is increasing.

“Members shall ensure that . . . rules of origin shall not themselves create restrictive, distorting, or disruptive effects on international trade.”<sup>12</sup>

Although RoO are playing an increasing role and despite the fact that they are important for international trade, RoO are considered to be obstacles to international trade when they are used as protectionist apparatuses and when their stringency leads to trade diversion. Therefore,, harmonizing and simplifying non-preferential and preferential RoO to be transparent, unbiased, predictable and objective<sup>13</sup> is the best solution to overcome the mentioned problems in order to facilitate international trade and achieve an efficacious globalization.<sup>14</sup>

Harmonizing both preferential and non-preferential RoO would cease all WTO member states from using RoO as concealed commercial policy and

<sup>9</sup> Simon P. Anderson & Nicolas Schmitt, *Non-Tariff Barriers and Trade Liberalization 1* (Univ. of Va., Dep’t of Econ., Working Paper No. 340, 2000), available at

<http://www.virginia.edu/economics/RePEc/vir/virpap/papers/virpap340.pdf>.

<sup>10</sup> Vermulst, *supra* note 6, at 3.

<sup>11</sup> Press Release, World Trade Organization, WTO Secretariat reports surge in new anti-dumping investigations (Oct. 20, 2008), available at [http://www.wto.org/english/news\\_e/pres08\\_e/pr542\\_e.htm](http://www.wto.org/english/news_e/pres08_e/pr542_e.htm).

<sup>12</sup> Agreement on Rules of Origin, *supra* note 2, at Art. II.

<sup>13</sup> *Id.* at art IX, § 1.

<sup>14</sup> Multi-stage production operations are considered to be one of the aspects of globalization that needs the imposition of flexible RoO worldwide since multi-national firms usually source inputs by practicing intra-trade between their branches that are located in more than one country. Usually, trading in computer parts is an example of the multi-stage production operations. See Kerry A. Chase, Address on Industry Lobbying and Rules of Origin in Free Trade Agreements, International Studies Association 48th Annual Convention 34-35 (Feb. 28-Mar. 3, 2007).

protectionist tools, would stop them from designing stringent, trade-diverting RoO, and would eliminate the variation in RoO along with their worldwide propagation. As a result, exporters and producers would not have to worry anymore about complying with different RoO imposed by different countries and RTAs all over the world, and would lead to the abatement of high administrative costs traders face.<sup>15</sup>

The WTO ARoO strives to harmonize the non-preferential RoO in a way that prevents such rules from becoming obstacles to trade. Non-preferential RoO were supposed to be harmonized and added as an annex to the agreement after three years from the commencement of the HWP. However, the harmonization process has not been finalized due to the existence of a number of outstanding issues and the refusal of the concerned WTO member states to settle these issues and complete the harmonization process of non-preferential RoO. This proves clearly the will of many WTO member states to use RoO as tools that protect their own national interests and susceptible goods.<sup>16</sup>

Once cooperation is expanded among the WTO member states to resolve the outstanding issues, and once the harmonization process is accomplished by the WTO CRO and TCRO under the under the aegis of the WCO (was the CCC which was formed in 1952),<sup>17</sup> non-preferential RoO will be harmonized, integrated in the agreement as an annex, and the WTO member states consequently will have to carry them out from the enforcement date specified by the ministerial conference.<sup>18</sup>

Having non-preferential RoO harmonized would supply the harmonization process of preferential RoO, if attempted, with a fine pattern that the preferential RoO should be based on when harmonized, i.e. to be based on the same fundamentals of harmonizing non-preferential RoO.<sup>19</sup> That is why harmonizing preferential RoO should be based on the norm that substantial transformation grants origin if the product is not wholly obtained, i.e. the application of the CTC method, reinforced, if needed by the VA and/or the Specific Processing test.<sup>20</sup>

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<sup>15</sup> WORLD TRADE ORGANIZATION, BUSINESS GUIDE TO THE WORLD TRADING SYSTEM: PART TWO INTERNATIONAL RULES GOVERNING TRADE IN GOODS (GATT 1994 AND ITS ASSOCIATE AGREEMENTS) 159, *available at* [www.jurisint.org/pub/06/en/doc/C12.pdf](http://www.jurisint.org/pub/06/en/doc/C12.pdf) (last visited May 2, 2009).

<sup>16</sup> See MANILA: ASIA DEVELOPMENT BANK, OFFICE OF REGIONAL ECONOMIC COOPERATION, HOW TO DESIGN, NEGOTIATE AND IMPLEMENT A FREE TRADE AGREEMENT IN ASIA 49 (2008).

<sup>17</sup> Agreement on Rules of Origin, *supra* note 2, art. IV, § 2.

<sup>18</sup> *Id.* art. IX, § 4.

<sup>19</sup> See the fundamentals of Article IX ARoO. *Id.*

<sup>20</sup> The VA is also known as the “ad valorem.”



It is to be noted, that the harmonization process of both non-preferential and preferential RoO shall not prejudice the interests of developing countries and shall not be partial to developed ones. Moreover, three more steps should be taken when harmonizing preferential RoO. The first is to apply the denominator and the numerator in accordance with the standards clarified by the Kyoto Convention when it comes to the application of the VC requirement. The second is not to permit cumulation rules, which preserve the origin of the good without being debilitated when it comes to importing inputs or components from a certain area or country, since they give rise to trade diversion in intermediate goods.<sup>21</sup> The third step is to get rid of any PSRoO.

This paper consists of three main parts. The first main part is about using RoO as a protectionist instrument. The second part considers trade diversion as an outcome of imposing stringent RoO. The third part is about harmonizing both non-preferential and preferential RoO. This paper illustrates how such harmonization could be achieved in order to overcome the problems facing international trade because of RoO, when such rules act as international trade obstacles. Furthermore, this paper provides suggested solutions that would alleviate the negative aspects of RoO and create a system that is transparent, predictable, and objective. In addition and most importantly, they would not hinder international trade.

## II. ROO AS PROTECTIONIST APPARATUSES: SPECIAL FOCUS IN THE TEXTILES AND CLOTHING SECTIONS

“... Members shall ensure that ... rules of origin are not used as instruments to pursue trade objectives directly or indirectly.”<sup>22</sup>

As a result of establishing various preferential contractual and/or autonomous trade regimes and lowering MFN tariffs in general, trade barriers have been reduced or eliminated. Consequently, countries started to use RoO as alternative barriers to trade in order to protect their own national interests and susceptible goods.<sup>23</sup> Hence, both non-preferential and preferential RoO

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<sup>21</sup> For further information about cumulation and other forms of RoO, see PAUL BRENTON, *RULES OF ORIGIN IN FREE TRADE AGREEMENTS* 2-3 (2003), <http://www.boaforum.org/06NewDown/5TradeNote%20on%20Rules%20of%20Origin.pdf>.

<sup>22</sup> Agreement on Rules of Origin, *supra* note 2, Art. 2(b).

<sup>23</sup> The term “trade objectives,” mentioned in Article 2(b) of the ARoO, refers to the prohibition of member states to use RoO as a protectionist tool. See Moshe Hirsch, *Rules of Origin as Instruments of Foreign and Domestic Policies* 16 (Paper submitted to the Conference on “The Politics of International Economic Law: The Next Four Years,” The American Society of International Law: Interest Group on International Economic Law, 2008).

can be used as protectionist apparatuses so long as they are not harmonized. Using non-preferential RoO as a protectionist tool is one of reasons that motivated the WTO to initiate the HWP; the aim was to establish a joint set of non-preferential RoO to be applied by all WTO member states worldwide.<sup>24</sup>

According to the aims of the principles of Article 2 of the WTO ARoO, the WTO member states are not anticipated to make any alterations to their RoO as far as the harmonization of non-preferential RoO is accomplished, because they could use such rules as protectionist instruments. Unfortunately, breaches to the aims of the WTO ARoO are already taking place.<sup>25</sup> As a result, disputes occurred. One such dispute, concerning the issue of altering RoO during the transition period, involved the United States and India.<sup>26</sup> The U.S. made some protectionist alterations (they were regarded to be so) to its apparel and textiles RoO that were enforceable as of the first of July 1996.<sup>27</sup> The EU, China, the Philippines, Bangladesh, and Pakistan were entitled to act as third parties.<sup>28</sup> India introduced the matter to WTO DSB, which decision was in favor of the U.S.<sup>29</sup>

Until the harmonization of non-preferential RoO, countries shall comply with “*status quo*”<sup>30</sup> and shall not make alterations to their RoO that suit their interests and protect their national susceptible goods. Otherwise, international trade will witness many disputes like the one previously mentioned. The harmonization of non-preferential RoO is needed to be completed soon in order to cease the occurrence of any dispute that could be aroused during the transition period, like the indicated U.S-India one, as a result of not complying with *status quo*.

Imposing stringent RoO in any RTA could lead to excessive demanding of regional (refers to the regional trade area) finished goods producers to regional intermediate goods because such demanding makes them more able to make production operations inside the regional trade area, comply thus with the RTA imposed stringent RoO, and claim consequently for the RTA preferences. As a result of the excessive demanding, regional intermediate goods prices would increase and regional intermediate goods

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<sup>24</sup>K.N. Harilal & P.L. Beena, *The WTO Agreement on Rules of Origin: Implications for South Asia 4* (Centre for Dev. Studies Working Paper No. 353, 2003).

<sup>25</sup> See *id.* at 34.

<sup>26</sup> Communication from the Permanent Mission of India to the Permanent Mission of the United States and to the Chairman of the Dispute Settlement Body (Jan. 22, 2002).

<sup>27</sup> Harilal & Beena, *supra* note 24, at 34.

<sup>28</sup> World Trade Organization, [http://www.wto.org/english/tratop\\_e/dispu\\_e/cases\\_e/ds243\\_e.htm](http://www.wto.org/english/tratop_e/dispu_e/cases_e/ds243_e.htm) (last visited May 17, 2010).

<sup>29</sup> See Vermulst, *supra* note 6, at 10-14.

<sup>30</sup> Harilal & Beena, *supra* note 24, at 34.

producers would be disguisedly protected.<sup>31</sup> Moreover, the regional finished goods producers would be protected because it might be too expensive on foreign competitors to invest in the regional trade area and simultaneously source expensive regional inputs to comply with the RTA Stringent RoO, especially if latter rivals used to import inputs from a more efficient outside suppliers<sup>32</sup> (sources of supply located outside of the regional trade area).

Krueger was right then when she said about FTAs that “a rule of origin may be a device through which producers of final goods and those of intermediate goods can be induced to support a FTA.”<sup>33</sup> However, that is not always the case because regional finished goods producers might forebear the preferences, import intermediate goods from outside suppliers by paying the MFN tariffs, and choose to trade regionally on MFN grounds rather than complying with the RTA stringent RoO since such rules always require costly and complex operations to be taken. Accordingly, both rivals (foreign and regional producers) would prefer to trade on a MFN basis.

As a result, inefficient regional intermediate goods producers would not find demands from either foreign rivals or regional finished goods producers to their inputs. Although stringent RoO imposed in a RTA may prevent foreign emulators from competing with regional producers, in some other cases, such rules may instead/simultaneously hinder the intra-regional trade; this would be contrary to the principle of the next mentioned article since they may not privilege both regional finished goods producers<sup>34</sup> and regional inefficient intermediate goods ones when the former choose to trade regionally on a MFN basis and when the latter consequently do not find demands for their intermediate goods. The low utilization rates of preferences, illustrated later on in this part, prove that point.

“The contracting parties recognize the desirability of increasing freedom of trade . . . through voluntary agreements . . . [T]he purpose of a customs union or of a free-trade area should be to facilitate trade between the constituent territories . . . .”<sup>35</sup>

Pursuant to the fundamentals of the previously mentioned GATT article, trade facilitation shall arise between the contracting parties to any RTA. Otherwise, the formation of any regional trade area will be pointless and useless. Accordingly, if stringent RoO were implemented in a RTA and

<sup>31</sup> Since sourcing inputs will be usually from them.

<sup>32</sup> Chase, *supra* note 14, at 18. See also Kerry A. Chase, *Protecting Free Trade: The Political Economy of Rules of Origin*, 62 INT’L ORG. 507, 513-14 (2008).

<sup>33</sup> Anne O. Krueger, *Free Trade Agreements as Protectionist Devices: Rules of Origin* 21 (Nat’l Bureau of Econ. Res., Working Paper No. 4352, 1993).

<sup>34</sup> Because of not utilizing the accorded preferences.

<sup>35</sup> General Agreement on Tariffs and Trade art. XXIV(4), Oct. 30, 1947, 61 Stat. pt. 5, 55 U.N.T.S. 194.

were about to hinder trade between the latter constituent parties, violating the principles of the stated GATT article XXIV will come to pass.

In preferential trade systems, RoO play a considerable role in avoiding trade deflection (transshipment of goods). However, too stringent RoO are applied in many RTAs not to avoid mainly trade deflection, but to protect the susceptible national products of some of the RTAs constituent parties at which the level the RoO stringency becomes more than that required to avoid trade deflection. As a result, complying with the indicated RoO will require costly and/or complex operations to be taken, and hence, the entry to the markets protected by the imposition of the RTAs restrictive RoO will be shackled with respect to the targeted competing products trying to enter them under the RTAs preferences.<sup>36</sup>

Although developing countries usually lack the employment of advanced operations when it comes to producing goods, they are characterized by inexpensive labor outlays needed during the production processes. That is why they benefit from the production of apparels since excessive expenditures and/or advanced operations are unnecessary to set up an enterprise in that industry.<sup>37</sup> This benefit could be nullified when a preference-granting country attempts to protect its domestic apparels by imposing too stringent RoO on the competing apparel products of developing countries trying to enter the market of the former under accorded preferences. Consequently, complying with the mentioned RoO will require costly and complex operations to be taken by the developing country which will prevent it from profiting from the accorded preferences and make it exceedingly difficult for its apparels to compete in the market of the preference-granting country. Thus, the developing country might not take advantage of the preferences and instead choose to trade with the preference-granting country on a MFN basis since this will not charge it the costly and the complex operations needed to be taken.

The following preferential trade forms clarify how RoO have been used as protectionist apparatuses.

#### *A. The European Union Generalized System of Preferences Rules of Origin*

The EU endeavored to harmonize its variegated applicable preferential RoO. In 1999, the EU tried to achieve this by applying a single set of PSRoO named "The Single List of PSRoO."<sup>38</sup> In July 2000, the EU applied the list in

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<sup>36</sup> PAUL BRENTON, TRADE, DOHA, AND DEVELOPMENT: A WINDOW INTO THE ISSUES 281-87 (2005).

<sup>37</sup> *Id.* at 283.

<sup>38</sup> Commission Regulation 46/1999, Adapting Certain Regulations and Decisions in the Fields of Free Movement of Goods, 1999 O.J. (L010) 1 (amending Regulation

its GSP regime.<sup>39</sup> Consequently, the single list was applied in the EBA Agreement as well since the latter is part of the EU GSP regime.<sup>40</sup>

The EU single list of PSRoO imposed on the clothing products categorized below chapters sixty-one and sixty-two (clothing products) of the HS the double transformation<sup>41</sup> notion.<sup>42</sup> According to this notion, yarns could be domestically obtained or imported from anywhere in the world. However, the yarns are required to be woven into fabrics in the preference-given country at which the fabrics are then to be fabricated into apparels qualified to be exported to the EU under the preferences given.<sup>43</sup> As a result, the imposed double transformation concept forbade the beneficiary developing countries from importing fabrics needed for the production of the apparels slated for export to the EU under the preferences granted. Specifically, the utilization of only domestic fabrics, EU fabrics (because of the bilateral cumulation done with the EU) or fabrics imported from the allowed regional cumulation zones was allowed.<sup>44</sup> However, importing EU fabrics is costly for developing countries.<sup>45</sup>

Exceptions to the double transformation notion were provided in chapter sixty-two for some non-crocheted garments, where a less restrictive

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2454/93 (EEC), laying down provisions for the implementation of Council Regulation 2913/92 (EEC), establishing the Community Customs Code.

<sup>39</sup> Alberto Portugal-Perez, *The Costs of Rules of Origin in Apparel: African Preferential Exports to the United States and the European Union*, in 39 POL'Y ISSUES IN INT'L TRADE AND COMMODITIES STUDY 4 (2008).

<sup>40</sup> The EBA initiative is part of the GSP regime at which the same rules apply to both of them. The EBA grants the fifty least developed countries special preferential treatments more than that accorded to the developing countries of the normal EU GSP regime. See European Trade Commission, [http://ec.europa.eu/trade/issues/global/gsp/eba/index\\_en.htm](http://ec.europa.eu/trade/issues/global/gsp/eba/index_en.htm) (last visited May 5, 2009); Taxation and Customs Union, European Commission, [http://ec.europa.eu/taxation\\_customs/customs/customs\\_duties/rules\\_origin/preferential/article\\_781\\_en.htm](http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_781_en.htm) (last visited May 5, 2009).

<sup>41</sup> It is known also by other variety of terms are: two-stage transformation, two-step conversion, multiple processing, two-stage conversion, fabric forward, or multiple transformation.

<sup>42</sup> See Portugal-Perez, *supra* note 39, at 4.

<sup>43</sup> *Id.* at 3-4.

<sup>44</sup> See also Taxation and Customs Union, European Commission, [http://ec.europa.eu/taxation\\_customs/customs/customs\\_duties/rules\\_origin/preferential/article\\_779\\_en.htm](http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_779_en.htm) (last visited May 5, 2009) (Additional information about various EU cumulation regimes).

<sup>45</sup> Janaka Wijayasiri, *Utilization of Preferential Trade Arrangements: Sri Lanka's Experience with the EU and US GSP Scheme* 34 (Asia-Pac Research & Training Network on Trade, Working Paper Series, No. 29, 2007).

VC rule was permissible to be applied as a substitution to the double transformation process.<sup>46</sup>

**The EU Double Transformation Process**

Yarns obtained from anywhere → \* weave them in the beneficiary country  
→ fabrics → fabricate the fabrics as well in the beneficiary country →  
apparel products qualified to be exported to the EU under preferences.

\* Stands for then.

The EU single list of PSRoO was characterized by its complicatedness at which the CTC method, mostly at the heading level of the HS, mixed with the VA and specific manufacturing operation approaches was applicable to a diversity of products.<sup>47</sup> The intricacy of the EU single list of PSRoO along with its double transformation notion (stringency) prevented many developing countries from benefiting from the EU GSP regime since they did not usually have the appropriate production capacity needed to comply with stringent RoO and since they rely, in most cases, on the utilization of imported materials when it comes to production.<sup>48</sup>

According to Ghoniem, “[o]nly [twenty one percent] of the eligible imports from GSP beneficiary countries into the EC actually benefited from GSP tariff preferences up to 1992.”<sup>49</sup> The situation since the year 2000 could be expected then what it has been like.

Sri Lanka is one of the developing countries that could not profit much from the EU GSP regime with regard to its textiles and apparels exportation. More than that, Sri Lanka’s average use of the preferences accorded to it under the EU GSP regime is poor with respect to “foodstuffs, beverages, and machinery & electrical equipment” because of its incapability to comply with the imposed EU GSP RoO.<sup>50</sup>

In response to the Tsunami crisis, the EU in 2005, granted Sri Lanka benefits, under the GSP+ system, more than those given through the ordinary EU GSP regime at which duty-free access to the EU were guaranteed for 7,200

<sup>46</sup> Further information about the single list of PSRoO is available at EC GSP Scheme, UNCTAD, <http://www.unctad.org/en/docs/poitcdtsbm25r1.en.pdf> (last visited Apr. 3, 2009).

<sup>47</sup> Antoni Estevadeordal, Jeremy Harris & Kati Suominen, *Multilateralising Preferential Rules of Origin around the World* 9 (Inter-Am. Dev. Bank, Working Paper Series No. #IDB-WP-137, 2009).

<sup>48</sup> MUNIR AHMAD, *IMPACT OF ORIGIN RULES FOR TEXTILES AND CLOTHING ON DEVELOPING COUNTRIES* 32 (2007).

<sup>49</sup> Ahmed Farouk Ghoneim, *Rules of Origin and Trade Diversion: The Case of the Egyptian-European Partnership Agreement*, 37 J. WORLD TRADE 597, 607-08 (2003) (first presented at the annual conference of Economic Research Forum in January 2002).

<sup>50</sup> Wijayasiri, *supra* note 45, at 35.

Sri Lankan products.<sup>51</sup> Unfortunately, Sri Lanka could not benefit from the GSP+ regime concerning its textiles and apparels exportation due to the stringency of the EU imposed double transformation rule of origin, taking into consideration that Sri Lanka relies mainly on imported yarns and fabrics when it comes to producing apparels.<sup>52</sup> To determine the extent of such reliance, it is worth mentioning that in Sri Lanka, the EU fabrics constitute eleven percent of the total fabric imports, the SAARC fabrics constitute twelve percent, the ASEAN fabrics constitute six percent and the fabrics imported from further zones constitute seventy one percent.<sup>53</sup>

China in fact is considered to be one of reasons that made the EU imposed stringent RoO in its GSP regime. It is regarded as a rival apparel provider. Many developing countries enrolled in the EU GSP regime source fabrics from China. For instance, in 2001, sixty-five percent of Bangladesh's total imported fabrics were from China<sup>54</sup> and forty-nine percent of Cambodia's total imported fabrics were from China as well.<sup>55</sup>

Because of the geographical location of many developing Asian countries near China, these developing countries could easily source low-priced and fine fabrics from China and use them in producing apparels. However, for the sake of staying away from such Chinese threat, the EU imposed the stringent double transformation rule of origin in its GSP regime to prevent the Chinese fabrics from entering its markets under preferences with the produced apparels of the beneficiary Asian developing countries and to induce the apparel producers of the latter to source materials from it rather than from more efficient Chinese sources of supply.<sup>56</sup> The incapability of many developing countries to comply with the imposed EU GSP RoO is manifested in the utilization proportions of their preferences under the EU GSP regime. Many developing Asian countries such as Laos, Bangladesh, Nepal, Cambodia, India, Sri Lanka, Vietnam and the Philippines could not

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<sup>51</sup> Asian Development Bank, *Asian Development Outlook 2006*, ROUTES FOR ASIA'S TRADE, Dec. 2006, at 18, <http://www.itcb.org/Documents/Impact%20Origin%20Rules.pdf>.

<sup>52</sup> *Id.*; see also Ratnakar Adhikari & Chatrini Weeratunge, *Textiles & Clothing Sector in South Asia: Coping with Post-quota Challenges*, in MULTILATERALISM AT CROSS-ROADS: REAFFIRMING DEVELOPMENT PRIORITIES 109 (2006).

<sup>53</sup> Wijayasiri, *supra* note 45, at 34-35.

<sup>54</sup> South Asia Watch on Trade, Economics & Environment, *Salvaging the Doha Round*, 3 TRADE AND DEVELOPMENT 9, (2004), available at <http://www.sawtee.org/pdf/publication/tadm8.pdf>.

<sup>55</sup> United Nations Conference on Trade and Development (UNCTAD), Trade Preferences for LDCs: An Early Assessment of Benefits and Possible Improvements, at 67, UNCTAD/ITCD/TSB/2003/8 (2003).

<sup>56</sup> See Paul Brenton & Miriam Manchin, *Making EU Trade Agreements Work: The Role of Rules of Origin* 13 (Centre for Eur. Pol'y Stud., Working Paper No. 183, 2002).

take advantage of the EU GSP system. The mean rate of utilizing the preferences of the mentioned countries under EU GSP regime for chapters 61 and 62 is considered to be low. From 1996 to 2000, the rate of Bangladesh, Nepal, Cambodia, and Laos was lower than fifty percent for chapters 61 and 62, while the rate of India, Sri Lanka, Vietnam and Philippine for the same chapters was lower than forty percent.<sup>57</sup>

Mahbubur Rahman, the president of the International Chamber of Commerce-Bangladesh, clarified that the imposed stringent RoO in the EU GSP regime did not help the LDCs to quite take advantage of the preferences accorded to them under the latter regime. He illustrated further that substituting the EU stringent RoO with appeased ones would “open an important window of opportunities for LDCs like Bangladesh”<sup>58</sup>

“The end justifies the means”<sup>59</sup>. . . It is well known, that developing countries need the preferences accorded to them by any preference-granting country. This need leads to the fact that sometimes a beneficiary country does not comply with an imposed stringent RoO of a unilateral trade regime, and illegally benefits through the preferences given to it under the regime. Benefiting illegally through the preferences happens when an origin certificate comes out unfairly or incorrectly, although compliance with the imposed stringent rule of origin has not taken place, i.e. when fraud takes place.

The Bangladesh T-shirts case is a realistic example for this.<sup>60</sup> From 1997 to 1998, Bangladesh’s mean “utilization” proportion of preferences under the EU GSP regime was lower than thirty percent. The main reasons behind this are the consequences of the Bangladesh T-shirts case. In March 1995, some EU customs authorities noticed a flow of imported T-shirts from Bangladesh. They decided to request the Department of Trade and Industry to check the validity of the T-shirts’ origin certificates. The EU member states, the EU commission, and EU customs authorities conducted an inspection concerning the issue. According to the results, ten thousand origin certificates did not come out correctly. Consequently, a fine and customs duties on all T-shirts that were exported to the EU “covered” by incorrect origin certificates were paid to the EU. In 1997, the total compliance with the imposed EU RoO became a condition to bring out origin certificates (form A)<sup>61</sup> for textiles and

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<sup>57</sup> UNCTAD, *supra* note 55, at 55-58.

<sup>58</sup> *Product Diversification Key to Utilizing EU Market Access Facility*, DAILY STAR, Feb. 26, 2006, available at <http://www.thedailystar.net/2006/02/24/d60224050145.htm>.

<sup>59</sup> This attributed quote belongs to Niccolò di Bernardo dei Machiavelli. The History Guide, <http://www.historyguide.org/earlymod/machiavelli.html> (last visited Apr. 11, 2010).

<sup>60</sup> UNCTAD, *supra* note 55, at 62.

<sup>61</sup> Form A is a GSP origin certificate. Form A certificates are brought out for only commodities that are produced in accordance with the imposed RoO. Moreover, such commodities shall be produced by plants registered in the Department of



apparel products exported from Bangladesh to the EU. This total compliance was the *raison d'être* of the mentioned drop in Bangladesh's utilization proportion of preferences under the EU GSP scheme from 1997 to 1998.<sup>62</sup>

What could be learned from the Bangladesh T-shirts case is that developing countries are in need of any preference accorded to them. If stringent RoO are going to be imposed to prevent them as much as possible from competing, improving, and thus utilizing the preferences, circumventing these rules, dealing with them as if they do not exist, and profiting at any cost could take place. As a result, cases and disputes would infiltrate international trade. Some would win those cases and others would lose. Some would win today and others would lose tomorrow, so why bother in the first place with imposing stringent RoO? Is it because of being afraid of competition? Being afraid of improvement? Being afraid of giving consumers choices? Imposing stringent RoO in a GSP regime could undermine the will of the beneficiary developing countries to take advantage of, or utilize, the accorded preferences. Alternatively, the beneficiaries might choose as a loophole to forebear the granted preference and trade with the preference-granting country on a MFN grounds rather than complying with the RoO.<sup>63</sup> Therefore, before imposing any GSP RoO in unilateral trade regimes, the preference-granting country should first gather statistics and information related to the production capability of the preference-given country, i.e., the amount of imported inputs needed for production, local resources and production firms. Pursuant to such gathered statistics, the RoO should be appropriately imposed. Otherwise, complying with the latter would be difficult and would need production operations that could not be taken easily by the beneficiary country since the latter would not have the sufficient supplies needed for production in accordance with the imposed RoO, leading to its inability to benefit from/utilize the preferences accorded to it under the unilateral regime. The only explanation that clarifies why a preference-granting country would not want to gather the mentioned statistics and accordingly apply appropriate RoO on a beneficiary country is to use RoO as protectionist apparatuses, i.e., to protect its susceptible products and national interests.

The EU commission brought out a green paper that evaluates the application of its RoO in preferential agreements, especially those done with

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Trade and Industry. More information about the Form A origin certificate and a sample is available at Trade and Industry Department of the Government of the Hong Kong Special Administrative Region. Trade and Industry Department, the Government of the Hong Kong Special Administrative Region, <http://www.tid.gov.hk/english/aboutus/publications/registcert/files/forma.pdf>; see HONG KONG TRADE AND INDUSTRY DEPARTMENT, HOW TO APPLY FOR A CERTIFICATE OF ORIGIN FORM A (2005), <http://www.tid.gov.hk/english/aboutus/publications/registcert/files/forma.pdf>.

<sup>62</sup>For more details about the case, see UNCTAD, *supra* note 55, at 62.

<sup>63</sup>Wijayasiri, *supra* note 45, at 5.

developing countries.<sup>64</sup> The paper illustrates that the insufficiency of manufacturing firms, investment chances or managerial systems in the beneficiary developing countries, along with the inefficiency of traders there to comprehend the complex imposed EU RoO, made it arduous for the beneficiary developing countries to comply with EU RoO and, consequently, benefit much from the preferences accorded to them by the EU. Furthermore, the green paper made clear that the main part of the EU preferential RoO was to protect the interests of the EU when they are applied to its imports.<sup>65</sup>

### *B. The South African Development Community*

The SADC member states urged the application of stringent RoO. As a result, crucial modifications were made to their protocol. Stringent PSRoO were implemented which substituted the double transformation test for the CTC method. Furthermore, such test was applicable, along with the specific manufacturing operation requirement, to a variety of products. In addition, the minimum value of imported materials allowed to be used in producing products was decreased, while the required VA of local inputs was increased. It is indeed noticeable that the SADC RoO became, after the mentioned modifications, as alike as the EU specified RoO. More importantly, they were used as well for protectionist purposes (which will be illustrated next).<sup>66</sup>

Because of the excessive existing pauperism in the four SADC member states of Malawi, Mozambique, Tanzania and Zambia (MMTZ), these countries were the only ones to be exempted from the application of the double transformation test<sup>67</sup> when exporting to the SACU<sup>68</sup> and subjected to limited quotas<sup>69</sup> up to 2005.<sup>70</sup>

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<sup>64</sup> See European Commission Green Paper on the Rule of Origin in Preferential Trade Arrangements, COM (2003) 787 final (Dec. 18, 2003).

<sup>65</sup> *Id.* at 7.

<sup>66</sup> P. Brenton, F. Flatters & P. Kalenga, *Rules of Origin and SADC: The Case for Change in the Mid-Term Review of the Trade Protocol* 16-17 (World Bank, Afr. Region Working Paper, Series No. 83, 2005).

<sup>67</sup> They instead have to comply with the single transformation rule.

<sup>68</sup> The SACU consists of only five members so far, which are: Botswana, South Africa, Swaziland and Lesotho.

<sup>69</sup> The MMTZ were subjected to limited quotas only on sugar, textiles and apparels. This actually indicates their sensitive nature.

<sup>70</sup> FRANK FLATTERS & ROBERT KIRK, RULES OF ORIGIN AS TOOLS OF DEVELOPMENT? SOME LESSONS FROM SADC 18, available at [http://www.unige.ch/ses/ecopo/demelo/Cdrom/RIA/Readings/Flatters\\_Kirk03.pdf](http://www.unige.ch/ses/ecopo/demelo/Cdrom/RIA/Readings/Flatters_Kirk03.pdf). See also SOUTHERN AFRICAN DEVELOPMENT COMMUNITY (SADC), PROCEDURES MANUAL ON THE IMPLEMENTATION OF THE RULES OF ORIGIN APPENDIX I OF ANNEX I OF THE SADC PROTOCOL ON TRADE 7 (2004), <http://www.sadc.int/attachment/download/file/7>.

Regarding the textile and apparel production, the SADC focused mostly on its inter-regional trade and on the utilization and of its regional materials. More often than not, it favored selling its apparel products regionally and preferred turning away from competing internationally. Accordingly, the SADC implemented the stringent RoO and the double transformation norm: to force the regional producers who seek the preferences to use local and regional components when producing apparels and to assure consequently the inability of producers using imported materials to enjoy the preferences and compete regionally with the former producers. Unfortunately, apparel producers of the SADC member states do not have the capability to produce the materials needed for producing apparels.<sup>71</sup>

As long as most apparel producers in the SADC need imported materials when producing apparels<sup>72</sup> and as long as sourcing such materials from outside of the region needs the facilitation of their importation by the application of appropriate RoO, which is not the case in the SADC, the SADC would not therefore improve in its textiles and apparels production. As a result, the SADC apparel products would not be able to internationally compete with foreign apparel ones,, unless appropriate pliancy and facilitations<sup>73</sup> concerning production are to be offered for the SADC producers since facilitating trade has been proven to be the most efficient way that improves production and encourages hence international competition.<sup>74</sup> For instance, South Africa has one of the world's best kettle outlets. It "accounts for about 4 percent of the entire global market for electric kettles."<sup>75</sup> Although local producers in South Africa favor using local inputs when it comes to production, importing cord sets from China from time to time takes place in order to use them as inputs in producing kettles. In many other cases, South Africa imports inputs from other foreign markets. For example, electronic motors from Italy were used to produce electronic sweepers that were exported to the Middle East. Facilitating trade and the ability to source inputs from efficient sources of supply are the main causes of improvement and were the

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<sup>71</sup> REG'L AGRIC. TRADE EXPANSION SUPPORT PROGRAM (RATES), COTTON AND TEXTILE REGIONAL TRADE POLICY PAPER: IN SEARCH OF REGIONAL STRATEGIES FOR EXPANDING INTRA AND EXTRA REGIONAL TRADE IN COTTON AND TEXTILE PRODUCTS, A FINAL REPORT 19 (2005), *available at* [http://dec.usaid.gov/index.cfm?p=search.getCitation&CFID=7775&CFTOKEN=99688013&rec\\_no=153040](http://dec.usaid.gov/index.cfm?p=search.getCitation&CFID=7775&CFTOKEN=99688013&rec_no=153040).

<sup>72</sup> For example, South Africa depends on the importation of materials when producing apparels and would never be able to compete globally, if sourcing materials from outside the region is not allowed.

<sup>73</sup> Pliancy and facilitations can take place by not imposing stringent RoO, as a tolerant VC requirement (which will help in importing inputs from efficient producers), and by reducing the MFN tariffs on the imported inputs wanted to be used in production.

<sup>74</sup> Brenton, *supra* note 66, at 27, 30-31.

<sup>75</sup> FLATTERS & KIRK, *supra* note 70, at 13.

main reasons that made the South African kettle industry improve and compete globally.<sup>76</sup>

### C. *The African Growth Opportunity Act*

The U.S. under the AGOA<sup>77</sup> applied to the imported non-apparel products of the beneficiary sub-Saharan African countries a flexible rule of origin that is a thirty-five percent across-the-board VC requirement.<sup>78</sup> However, the U.S. applied the stringent triple transformation rule<sup>79</sup> to imported apparel products of the beneficiaries, taking into consideration that apparels are deemed to be sensitive products for the U.S.<sup>80</sup>

An exception to the application of the triple transformation rule was accorded to LDBCs until September 30, 2007, which allowed them to use fabrics sourced from a third country when producing apparels.<sup>81</sup> All of the AGOA beneficiaries are categorized as LDBCs, with an exception to only four of them: Gabon, South Africa, Seychelles, and Mauritius.<sup>82</sup>

The U.S. has been applying a special rule to LDBCs that will expire by September 30, 2012. The rule grants the apparel exports of the latter to the

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<sup>76</sup> *Id.* at 16.

<sup>77</sup> The AGOA is a legislation that was signed by the former U.S. President Bill Clinton and ratified by Congress accepted by the congress in May, 2000. The act was supposed to expire in 2008, but then the former U.S. President Bush came and extended its duration until September 30, 2015, by the AGOA Acceleration Act of 2004 (AGOA III). *See* Trade and Development Act of 2000, Pub. L. No. 106-200, 114 Stat. 251 (2000); AGOA Acceleration Act of 2004, Pub. L. No. 108-274, 118 Stat. 820 (2004); African Growth and Opportunity Act of 2000, Pub. L. No. 106-200, 114 Stat. 252 (2000).

<sup>78</sup> OFFICE OF THE U.S. TRADE REPRESENTATIVE, AFRICAN GROWTH AND OPPORTUNITY ACT IMPLEMENTATION GUIDE 6 (2000). *See also* AGOA.info, [http://www.agoa.info/index.php?view=about&story=rulesof\\_origin](http://www.agoa.info/index.php?view=about&story=rulesof_origin) (last visited Feb. 10, 2010).

<sup>79</sup> The triple transformation rule is also known as the three-stage conversion, the yarn forward rule, or the triple-stage transformation.

<sup>80</sup> Most of the exports from the AGOA countries, Nicaragua, El Salvador, Jordan, Costa Rica, Dominican Republic, Guatemala, Honduras, Haiti and Mexico to the U.S. are apparels, which clarifies the sensitivity of apparel products worldwide and in the U.S. when it comes to international trade. *See* AHMAD, *supra* note 48, at 20.

<sup>81</sup> AGOAinfo, [http://www.agoa.info/index.php?view=about&story=apparel\\_rules](http://www.agoa.info/index.php?view=about&story=apparel_rules) (last visited Feb. 10, 2010).

<sup>82</sup> It is to be noted that the AGOA Acceleration Act applied the Exception to Mauritius (accorded it "LDBCs status") for only one year, until September 30, 2005. *See* Commercial Availability of Fabric and Yarns in AGOA Countries: Certain Denim, Investigation No. AGOA--07--001, at C04 (U.S. Int'l Trade Comm'n (USITC), Publication 3950 (Sept. 30, 2007). *See also* AGOAinfo, <http://www.agoa.info/index.php?view=download&story=maps> (last visited Feb. 10, 2010) (for information about the LDBCs status).

U.S. “duty- and quota-free treatment” and allows them further to employ fabrics and yarns imported from anywhere in the world when producing apparels. However, in order to benefit from the special rule, the assembly must be done in one or more of the LDBC. In addition, the apparel products exported to the U.S. under the special rule are submitted to a cap (quantitative limitation).<sup>83</sup> Pursuant to the AGOA triple transformation rule, yarns are to be sourced from the U.S. or a beneficiary country.<sup>84</sup> Afterwards, the yarns are woven into fabrics in the preference-given countries or the U.S. at which the fabrics thereupon should be fabricated into apparels qualified consequently to be exported to the U.S. under the accorded preferences.<sup>85</sup>

### **The AGOA Triple Transformation Process**

Yarns sourced from the preference-given countries or the U.S → weave them in the U.S or a beneficiary country → fabrics → fabricate the fabrics → apparel products qualified to be exported to the U.S under preferences.

In point of fact, both of the triple and double transformation rules are used as protectionist instruments. Although both of them are used for such same purpose by the U.S. and the EU, it is unambiguous to realize that the stages of protection targeted by each one of them are different.<sup>86</sup>

Since the AGOA triple transformation process does not allow sourcing yarns and fabrics from anywhere other than the U.S. or the beneficiary countries, it is therefore, more restrictive than the double transformation process. The difference between the levels of their stringency is obviously reflected in their names: triple and double.

Although the stringency of the triple transformation rule could help in deterring trade deflection from happening, its level is quite more than that needed to avoid the deflection.

Actually, there are other appropriate alternatives that can be used to fulfill the same aim.

<sup>83</sup> See OFFICE OF THE U.S. TRADE REPRESENTATIVE, 2007 COMPREHENSIVE REPORT ON U.S. TRADE AND INVESTMENT POLICY TOWARD SUB-SAHARAN AFRICA AND IMPLEMENTATION OF THE AFRICAN GROWTH AND OPPORTUNITY ACT 16 (2007), available at

[http://www.ustr.gov/sites/default/files/asset\\_upload\\_file762\\_11294pdf.11294.pdf](http://www.ustr.gov/sites/default/files/asset_upload_file762_11294pdf.11294.pdf).

<sup>84</sup> In fact, this is diagonal cumulation.

<sup>85</sup> THE SERVICES GROUP, INC., SOUTHERN AFRICA GLOBAL COMPETITIVENESS HUB: RULES OF ORIGIN, “COMMERCIAL AVAILABILITY” AND TRADE PREFERENCES: DENIM AND AGOA (2007), available at

[http://qed.econ.queensu.ca/pub/faculty/flatters/writings/ff\\_denim\\_agoa.pdf](http://qed.econ.queensu.ca/pub/faculty/flatters/writings/ff_denim_agoa.pdf).

<sup>86</sup> Aaditya Mattoo, Devesh Roy & Arvind Subramaniand, *The Africa Growth and Opportunity Act and its Rules of Origin: Generosity Undermined?* 18 (World Bank, Policy Research Working Paper No. 2908, 2002).

Teasing the cotton, spinning it, weaving the yarns, fabricating the fabrics, adorning the apparels and all clothing production processes can be simply checked up by officially surveying the apparel production firms and scrutinizing their stocktaking books, package deals and demands.<sup>87</sup> Thus, using the triple transformation rule as a disguised protectionist device is the only reason that explains why the U.S. prefers applying it, although the existence of the other suitable options that could be used to avoid the trade deflection.

In truth, the beneficiary sub-Saharan African developing countries could have taken advantage of the AGOA five times more, if RoOs were not imposed on them.<sup>88</sup>

Primarily, in AGOA, a plain single transformation rule<sup>89</sup> was going to be the applicable one to the apparel products imported to the U.S. by the preference-given countries. However, the U.S. clothing “industry” turned it down and was the one that had a great impact on applying instead the triple transformation rule, which obstructed the aim of providing employment opportunities in the region.<sup>90</sup> As a matter of fact, this came to pass because the U.S. materials are, indeed, not as catchy and emulative as the Asian ones.<sup>91</sup> What happened in 2003 and 2004 illustrates this point. In 2003, only nineteen percent of the beneficiaries’ apparel exports to the U.S. under AGOA were produced by the usage of regional- or domestic-sourced materials.<sup>92</sup> In 2004, just 2.2% of the U.S market was held by the preference-given countries, taking

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<sup>87</sup> *Id.* at 7.

<sup>88</sup> Fabien Candau & Jean Sébastien, *What are European Union Trade Preferences Worth for Sub-Saharan Africa and Other Developing Countries*, in TRADE PREFERENCE EROSION MEASUREMENT AND POLICY RESPONSE 65-102 (2009).

<sup>89</sup> The single transformation rule is also known as the single-stage conversion rule. It is when the yarns and fabrics used in producing the apparels are permitted to be sourced from a third country.

<sup>90</sup> INT’L TRADE CENTRE, FOSTERING TRADE THROUGH PUBLIC-PRIVATE DIALOGUE: BUSINESS IMPLICATIONS OF EPA NEGOTIATIONS FOR SADC 12 (2007). This report was prepared for a Regional Experts Meeting for South African Development Community at Stellenbosch, South Africa, June 11-12, 2007. An example of the employment opportunities that were obstructed is what happened in South Africa from 2002 until 2005, when 37,723 positions were lost. INST. FOR GLOBAL DIALOGUE, CASE STUDY: THE CLOTHING INDUSTRY IN SOUTH AFRICA 3 (2005), available at [http://www.cuts-citee.org/documents/CASE\\_STUDY-SA.doc](http://www.cuts-citee.org/documents/CASE_STUDY-SA.doc).

<sup>91</sup> They are not as the Asian ones because of the high quality and low price of the Asian materials, mainly china as mentioned before. Besides, the transportation costs from China are cheaper than from the U.S. See Mattoo, *supra* note 86, at 13. See also MATTHIAS KNAPPE, REPORT AT UNCTAD INTERGOVERNMENTAL EXPERT MEETING ON DYNAMIC AND NEW SECTORS OF WORLD TRADE TEXTILES AND CLOTHING 8 (2005).

<sup>92</sup> Leanne R. Sedowski, *Hanging by a Thread?: The Post-MFA Competitive Dynamics of the Clothing Industry in Madagascar* 29 (Research Report No. 78, 2008).

into account that the apparel products constituted ninety six percent of their exports to the U.S. More importantly, eighty six percent of beneficiaries exported apparel products were produced from Asian fabrics, while a fourteen percent of them were produced from African fabrics.<sup>93</sup> That is why the triple transformation rule was imposed by the U.S.: to induce the AGOA beneficiaries<sup>94</sup> to use only U.S. or regional materials when producing apparels,<sup>95</sup> to help hence the U.S. clothing industry in supplying its undesired materials to the beneficiaries<sup>96</sup> and to guarantee therefore the inability of the Asian competitive materials to enter the U.S. markets under preferences with the imported apparel products of the beneficiary countries.. This then proves that both the triple and double transformation processes were used for the same aim, i.e. as protectionist apparatuses.

Using RoO as protectionist instruments, shackling the importation of materials on specific countries, making the latter bound to source costly components and coercing them to undertake high technological production processes are all reasons that could weaken the utilization of the preferences provided under any RTA. It is worth mentioning then that the consequences of applying the triple transformation rule in AGOA were brought to light in 2002. In that year, the Mauritian and South African apparel exports to the U.S. constituted ninety percent and four percent of their total exports there. Unfortunately, only forty one percent and forty seven percent of them took advantages of the given preferences.<sup>97</sup>

### 1. *The Flexibility of RoO Facilitates Trade and Spreads Welfare in Preferential Trade Regimes: the Experience of Lesotho*

“No other sector currently offers the same opportunities for stimulating growth, increasing employment and promoting technological transfers.”<sup>98</sup>

That was the impact of the apparel industry in Lesotho when its apparel exportation was facilitated because of exempting it from complying

<sup>93</sup> See Knappe, *supra* note 91, at 3.

<sup>94</sup> The author here refers to the four non-LDBCs.

<sup>95</sup> Only in case such apparels are needed to be exported to the U.S. under the preferences accorded, because if they are not, the beneficiaries therefore can import materials from anywhere in the world and choose instead paying rather the MFN tariffs.

<sup>96</sup> Because the producers who want to claim for the granted preferences have to demand materials from the U.S. in order for them to comply with the triple transformation rule.

<sup>97</sup> Brenton, *supra* note 66, at 6.

<sup>98</sup> ANDREW SALM ET AL., DEP'T FOR INT'L DEV., LESOTHO GARMENT INDUSTRY SUBSECTOR STUDY FOR THE GOVERNMENT OF LESOTHO 52 (2002).

with the AGOA triple transformation rule.<sup>99</sup> In addition, Lesotho witnessed more than a fifty percent increase in their job opportunities in the apparel section between 2000<sup>100</sup> and 2004.<sup>101</sup>

The United States Trade Representative Robert Zoellick once said, “I visited sub-Saharan Africa . . . and I stopped in Lesotho -- the first U.S. Cabinet official ever to be in Lesotho -- which sends some \$350-\$400 million of textile exports [to the United States] under AGOA.”<sup>102</sup>

In 2004, the apparel exports of Lesotho to the U.S. constituted \$455.9 million. This caused Lesotho to be the biggest apparel exporter to the U.S. that year.<sup>103</sup>

What happened in Lesotho proves that the imposition of tolerant RoO on developing countries facilitates their trade,<sup>104</sup> leads thus to their prosperity and helps them in the process of their development.

## *2. The Double-edged Sword Rule, Pessimistic Expectations for AGOA and How to Overcome the Foreseen Odds:*

The AGOA triple transformation rule is “a double-edged sword.” On the one hand, complying with it could induce the beneficiaries to augment and ameliorate their “capacities” in apparel production. On the other hand, it could obstruct the preference-given countries from utilizing the accorded preferences, if they do not have the mentioned capacities needed to produce

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<sup>99</sup> BERNARD HOEKMAN, WORLD BANK, OPERATIONALIZING THE CONCEPT OF POLICY SPACE IN THE WTO: BEYOND SPECIAL AND DIFFERENTIAL TREATMENT 3 (2004). *See also* BERNARD HOEKMAN, WORLD BANK, DEVELOPMENT AND THE GLOBAL TRADE ARCHITECTURE: AN OVERVIEW OF THE GLOBAL TRADE AND FINANCIAL ARCHITECTURE PROJECT 15 (2005).

<sup>100</sup> This is the year when the AGOA got accepted by the congress.

<sup>101</sup> *Commission Staff Working Document on Communication on the Rules of Origin in Economic Partnership Agreement Regional Negotiations: Impact Assessment of Rules of Origin for Textiles and Clothing*, at 20, SEC (2007) 1168 (Sept. 11, 2007) (paper accompanied the communication from Mr. Kovacs and Mr. Mandelson to the Commission in Agreement with Mr. Michel, Brussels).

<sup>102</sup> Charles W. Corey, *Zoellick Says, New Mood, Will in Africa to Create Opportunity*, WASH. FILE, Feb. 16, 2005, available at [http://www.allamericanpatriots.com/2006268\\_\\_zoellick\\_says\\_new\\_mood\\_will\\_africa\\_create\\_opportunity](http://www.allamericanpatriots.com/2006268__zoellick_says_new_mood_will_africa_create_opportunity).

<sup>103</sup> MIKE MORRIS & LEANNE SEDOWSKI, TRADE AND INDUSTRIAL POLICY SECRETARIAT, GLOBALIZATION AND THE POST MFA ENVIRONMENT: THE COMPETITIVE DYNAMICS AND POLICY RESPONSIVENESS OF THE CLOTHING INDUSTRY IN MADAGASCAR 7 (2005).

<sup>104</sup> Trade in mainly apparel products since developing countries are characterized by their inexpensive labor outlays needed during the apparel production processes.



apparels pursuant to the rule.<sup>105</sup> Therefore, RoO imposed in any autonomous trade regime should be proportionate with the production capacities of the beneficiaries.

The production capacity can be calculated by gathering statistics and information about the established capacity of the preference-given country and by knowing to what range such country uses its established capacity.<sup>106</sup>

The best level of production capacity occurs when a kind of equilibrium between the established capacity and capacity utilization takes place. For instance, in 2003, the spinning capacity (established capacity) of South Africa was 638,000 spindles and its utilization to the capacity (production) was seventy eight percent – eighty four percent.<sup>107</sup> The capacity utilization of Mauritius the same year was high as well (seventy five percent to eighty percent).<sup>108</sup> This, in fact, proves why the U.S. did not apply the special rule to South Africa and Mauritius. There is another example that indicates the contrary and happened also in 2003. In that year, the spinning and weaving capacities of Malawi were 70,000,000 and 60,000,000 square meters. However, the utilization of its capacities was 4.3% and zero percent.<sup>109</sup> Since the utilization of Malawi to its capacity was that much low, it would not have been able to produce apparels pursuant to the triple transformation rule, if the exception and special rule were not applied to it. Thus, after September 30, 2012 (the deadline of the application of the special rule), no positive effects could be expected to take place in sub-Saharan Africa because of the AGOA.

LDBC's that have the same problem as Malawi<sup>110</sup> would not be able to benefit from the AGOA preferences in the apparels sector since they rely mainly on the importation of materials rather than producing them<sup>111</sup> and since they will not be able as a result to comply with the triple transformation rule, unless an extension to the duration of applying the special rule to them is to happen.

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<sup>105</sup> Frank Flatters, *Rules of Origin and AGOA: Hard Choices for Textiles and Clothing*, in SADC 3 (June 30, 2002), available at [http://qed.econ.queensu.ca/faculty/flatters/writings/ff\\_hard\\_choices.pdf](http://qed.econ.queensu.ca/faculty/flatters/writings/ff_hard_choices.pdf).

<sup>106</sup> The idea illustrates the importance of gathering information about the “installed capacity” and “capacity utilization” of any beneficiary. See also COMESA, COTTON AND TEXTILE REGIONAL TRADE POLICY PAPER: PROPOSALS FOR A REGIONAL POLICY PLATFORM IN SUPPORT OF REGIONAL VALUE CHAIN (2005), available at <http://www.actif africa.com> (for information about the LDBC's status).

<sup>107</sup> *Id.* at 9.

<sup>108</sup> *Id.* at 10.

<sup>109</sup> *Id.*

<sup>110</sup> See *id.* For example, while the spinning capacity of Tanzania in 2003 was 64,355 MT, its utilization to the capacity was only 41.7%.

<sup>111</sup> They barely have the ability in that case to produce apparel because their installed capacity might be insufficient to be highly utilized, because their utilization to their capacity is low or both.

As for non-LDBC, the continuance of applying the triple transformation rule along with its “capital-intensive nature” to them could tire out their production capacity, even if it was deemed to be high before, leading potentially to their inability to comply with the triple transformation rule in the future and benefit consequently from the AGOA preferences.<sup>112</sup>

According to the current available information, the previous mentioned expectations would happen to South Africa, even though its capacity utilization was deemed to be high in 2003.

Since 2005, the amount of South Africa’s apparel exports to the U.S. has been declining.<sup>113</sup> In 2007, a South African apparel company’s managing director said, “The local textile industry can’t give us what we need in terms of quality, delivery and service.”<sup>114</sup> That is why South Africa, to a considerable

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<sup>112</sup> Because of the imposed double transformation rule in the EU GSP regime “most least-developed countries are unable to take full advantage of the facility, lacking as they are in textile manufacturing capacity due to the highly capital-intensive nature of this segment of textile and clothing production”. Ahmad, *supra* note 48, at 10. Moreover, a significant portion of clothing is made with fabrics of new fibres with technologies patented in the developed world.” *Id.* Since the double transformation needs that kind of capital and technological operations, the triple transformation rule is considered to be then a bigger problem for the beneficiaries of the AGOA and all other regimes using the same rule, as the U.S.–Singapore FTA (USSFTA). United States –Singapore Free Trade Agreement, U.S.–Sing., May 6, 2003, 117 Stat. 948 (2003), *available at* <http://www.dfat.gov.au/trade/negotiations/safta/index.html>.

<sup>113</sup> MIKE MORRIS & LEANNE SEDOWSKI, GLOBALIZATION AND THE POST MFA ENVIRONMENT, TIPS/DPRU FORUM 2005: TRADE AND UNEVEN DEVELOPMENT: OPPORTUNITIES AND CHALLENGES 7 (2005), *available at* <http://www.tips.org.za/files/779.pdf>. In this reference and at that page, it is stated that the exports of South Africa “now trails substantially behind.” The word “now” pursuant to the year of publishing the reference stands for the year 2006.

<sup>114</sup> When South Africa tried to encourage the sourcing of its domestic materials by imposing quotas on the Chinese fabrics, many South African apparel producers became discomfited. One of them said “three production lines are standing empty because orders have dried up due to the unavailability of certain quota-affected fabric; and ... [our] intimate wear factory has shrunk to half its size.” See THE SERVICES GROUP, SOUTHERN AFRICA GLOBAL COMPETITIVENESS HUB, RULES OF ORIGIN, “COMMERCIAL AVAILABILITY” AND TRADE PREFERENCES: DENIM AND AGOA 10 (2007), *available at* [http://qed.econ.queensu.ca/faculty/flatters/writings/ff\\_denim\\_agoa.pdf](http://qed.econ.queensu.ca/faculty/flatters/writings/ff_denim_agoa.pdf). Another one said “we’re battling to get fabric and our CMT suppliers suffer because we can’t give them the work flow. They’re sitting without work so their efficiency goes out of the window.” *Id.* This really indicates that, if the AGOA triple transformation rule is going to be continuously imposed on all of the South African apparels along with all other non-LDBC, all of the latter would not have the ability to comply anymore with it because of the declination that is happening to the level of their capacity.

extent, does not have anymore the capacity needed to produce apparels using domestic materials, although its apparel producers have the desire to do so.<sup>115</sup> If South Africa is facing the specified circumstances, although its capacity utilization was high in 2003 and although it was one of the biggest apparel exporters to the U.S. under AGOA in 2004,<sup>116</sup> what have happened to the rest of the non-LDBC could be imagined. That is why, South Africa, along with all other non-LDBCs, is not expected to benefit much from the AGOA in the near future as long as the triple transformation rule is exhausting all of the their production capacity and as long as they are not allowed to use materials sourced from a third country when producing apparels needed to be exported to the U.S. under the AGOA preferences.

Another incident that should be taken into consideration before it is too late for the beneficiaries to benefit from the AGOA is the expiration of the ATC<sup>117</sup> in 2005 since it has resulted in shutting down firms and since it has caused a loss to many positions in both Lesotho and Swaziland.<sup>118</sup>

The fact that the non-LDBCs are running out of capacity and the fact that the LDBCs are running out of time to comply with the special rule implies that all of them do not deserve to face more obstacles in the future when claiming for the AGOA preferences.

Since the reported aim of the AGOA is to ameliorate the economy of beneficiary sub-Saharan African countries<sup>119</sup> and since the provided preferences in any RTA aims at improving the industries of the contracting parties, the application of appropriate AGOA RoO suiting the production capability of the beneficiaries, also taking into consideration any visible future expectations concerning their capacity, is hence necessary for the achievement of the mentioned amelioration and improvement.<sup>120</sup> Otherwise, the imposition of the AGOA triple transformation rule on the beneficiaries in 2012, or any too stringent rule of origin, would not help in the improvement of their apparel production,<sup>121</sup> would hinder their intra-regional trade, would not ameliorate thus their economy, and would not encourage them as a result to claim for the AGOA preferences. Consequently, the preference-given countries would not have the ability to globally compete.

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<sup>115</sup> *Id.*

<sup>116</sup> See MORRIS & SEDOWSKI, *supra* note 113, at 7.

<sup>117</sup> The ATC is also known as the Multi Fibre Arrangement.

<sup>118</sup> Morris & Sedowski, *supra* note 113, at 35.

<sup>119</sup> See 19 U.S.C. § 3701 (2000).

<sup>120</sup> See STEFANO INAMA, TRADE PREFERENCES FOR LDCS: AN EARLY ASSESSMENT OF BENEFITS AND POSSIBLE IMPROVEMENTS at xii (2003).

<sup>121</sup> *Id.* at 82.

#### D. *The NAFTA*

“Free trade is not based on utility but on justice.”<sup>122</sup> Many believe that the NAFTA RoO is one of the most complex RoO applied in preferential trade regimes.

According to Estevadeordal, the NAFTA and the EU RoO systems are “both among the most complex regimes in the world.”<sup>123</sup>

By using the three means of determining origin (the CTC, the RVC requirement and the specific manufacturing operation), the NAFTA RoO<sup>124</sup> are imposed on products classified “mostly at the 6-Digit tariff line level” of the HS.<sup>125</sup>

The stringency of the NAFTA RoO mainly takes place when the combination of more than one means of determining the origin becomes a single rule that is requisite for a product to comply with, for instance, the rule that requires the product to comply with a CTC test along with a VC requirement is more restrictive than the one requiring solely the CTC test. Furthermore, the restrictiveness of the CTC test varies according to the level at which the required change should be done (i.e. the CTCh requirement is more restrictive than the CTH one; which is more restrictive than the CTSH; which is more restrictive than the CTI).<sup>126</sup> Moreover, the value of the non-originating inputs permitted to be utilized under the tolerance rule (or *de minimis*), which treats a fixed magnitude of non-originating components used in producing a final product as if they are originating,<sup>127</sup> is set at only 7%.<sup>128</sup> More than that, the tolerance rule is implemented on the grounds of weight for apparel

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<sup>122</sup> The attributed quote belongs to Edmund Burke. Thinkexist.com, [http://thinkexist.com/quotes/edmund\\_burke/4.html](http://thinkexist.com/quotes/edmund_burke/4.html) (last visited Feb. 10, 2010).

<sup>123</sup> Estevadeordal, *supra* note 47, at 28.

<sup>124</sup> Full details about such Rules could be seen in Annex 401 of the NAFTA. North American Free Trade Agreement, U.S.-Can.-Mex., Dec. 17, 1992, Annex 401, available at <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/nafta-alena/ann-401-03.aspx?lang=eng> (containing full details about such Rules).

<sup>125</sup> Antoni Estevedeordal, *Negotiating Preferential Market Access: The Case of NAFTA*, 34 J. OF WORLD TRADE 12 (2000).

<sup>126</sup> *Id.*

<sup>127</sup> Miriam Manchin & Annette O. Pelkmans-Balaoing, *Rules of Origin and the Wed of East Asian Free Trade Agreements* 6 (World Bank Pol’y Research, Working Paper No. 4273, 2007).

<sup>128</sup> This value is considered to be low, especially if compared with other tolerance rules of other preferential regimes. For example, under the EU GSP regime and the Cotonou agreement the *de minimis* is set at ten percent and fifteen percent. See Paul Brenton, Notes on Rules of Origin with Implications for Regional Integration on Southeast Asia, Presented at Pacific Econ. Cooperation Council Trade Forum 28 (2003).

products instead of value of non-originating inputs.<sup>129</sup> Besides, it “does not extend to the production of dairy produce, edible products of animal origin, citrus fruit and juice, instant coffee, cocoa products, and some machinery and mechanical appliances.”<sup>130</sup> Under the NAFTA, nearly seventy five percent of all of the classified products are required to undergo the CTCh or the CTH tests to be conferred the “originating status.” In addition, nine percent and thirteen percent of them must comply with VC requirements and specific manufacturing operation.<sup>131</sup> The effect of such stringent RoO was reflected in Mexican exports to the U.S. at which the average of their utilization of the NAFTA preferences was low.<sup>132</sup>

### 1. *Automobiles*

One of the stringent NAFTA RoO concerns automobiles at which a high RVC requirement of 62.5% is imposed on “automotive goods” to be calculated by using the net cost method.<sup>133</sup> In that case, the CTH test was not enough to be solely applied without the VC requirement rule.<sup>134</sup> The aim of imposing such a stringent NAFTA Rule of origin is to prevent foreign auto manufacturers (mainly Japanese, Korean and German) from competing with those of the U.S.: by impelling the former, if seeking the preferences, to source inputs from inside of the region,<sup>135</sup> which is deemed to be a difficult task for them to do,<sup>136</sup> by trying to make them hence unable to comply with the VC requirement and by attempting to prevent them thus from acquiring the preferences, contrary to the American automotive industry that is able to comply and acquire accordingly the preferences.<sup>137</sup>

The weightiness of the NAFTA RoO for mainly the U.S. automobile industry is manifested in the “pressure” of the latter for them and in the long containment of such rules in the agreement which is approximately 200 pages.<sup>138</sup>

<sup>129</sup> North American Free Trade Agreement, *supra* note 124, at ch. 4, art. 405.

<sup>130</sup> Estevadeordal, *supra* note 47, at 18.

<sup>131</sup> Chase, *supra* note 14, at 21.

<sup>132</sup> Estevadeordal, *supra* note 47, at 7.

<sup>133</sup>  $RVC = \frac{\text{Net cost} - \text{Value of non Originating Materials}}{\text{Net cost}} \times 100$ . See North American Free Trade Agreement, *supra* note 124, at ch. 4, art. 402(3).

<sup>134</sup> See *id.*, at ch. 4, art. 403.

<sup>135</sup> In case they seek complying with the RVC requirements to acquire consequently the preferences.

<sup>136</sup> Because beside the large amount of capital needed to establish in the region and invest there, the emulators will have to source from the region inputs that could be less efficient if compared to those they might have used to source from.

<sup>137</sup> See Chase, *supra* note 14, at 34.

<sup>138</sup> Kala Krishna, Rules of Origin 3 (Apr. 2006) (unpublished article, available at <http://econ.la.psu.edu/~kkrishna/ROOS.pdf>).

The pressure for the imposition of the stringent RoO concerning automotive products has been largely carried by the U.S. “automakers” *Chrysler* and *Ford* and U.S. “[a]uto parts makers.”<sup>139</sup> Even though the imposition of the 62.5% RVC rule was pre-described as being high and is considered to be so, *Chrysler* and *Ford* sought the imposition of “a higher” RVC of about seventy percent in order to guard themselves more from their “foreign” rivals.<sup>140</sup>

## 2. Ketchup

Another protectionist NAFTA rule of origin is the one that says, “A change to tariff item 2103.20.aa from any other chapter, except from subheading 2002.90.”<sup>141</sup> This rule grants the originating status for the ketchup (2103.20) that is produced from imported tomatoes (any other chapter). However, the rule does not allow for a ketchup to be manufactured from a tomato paste that is not sourced regionally (2002.90).<sup>142</sup> Otherwise, the ketchup will not be granted the originating status and will not be hence exported regionally under preferences. In that case, producing ketchup, the fulfillment of CTC test will be useless under the NAFTA, if the usage of imported tomato paste from outside of the region is going to take place when producing the ketchup.

Truly, the specified stringent rule of origin is imposed to induce the regional ketchup producers to source the needed paste from Mexican tomato paste producers rather than from those of Chile who sell it at a cheaper price due to efficiency.<sup>143</sup> Therefore, the whole rule has been used as a protectionist apparatus: to protect the previous mentioned Mexicans against competition from cheaper imported ketchup from Chile.

## 3. The Triple Transformation under NAFTA

One of the facts that proves the stringency of NAFTA RoO is the imposition of the triple transformation rule on apparel products “that are made

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<sup>139</sup> Vivian C. Jones & Michael F. Martin, *International Trade and Rules of Origin: Implications of Globalized Manufacturing*, CONG. REP. SERVICE 9 (June 10, 2008) (quoting FREDERICK W. MAYER, *INTERPRETING NAFTA: THE SCIENCE AND ART OF POLITICAL ANALYSIS* 157-58 (1998)).

<sup>140</sup> *Id.*

<sup>141</sup> North American Free Trade Agreement, *supra* note 124, at Annex 401, ch. 21.

<sup>142</sup> Such exception is known as the “negative test”, at which satisfying the CTC will not grant the originating status to the product, if the exception is not respected. *See* Brenton, *supra* note 128, at 20.

<sup>143</sup> *Id.* It is to be noted that, Canada was allowed to use imported Chilean tomato paste when producing ketchup needed to be exported then to the U.S. under the Canada – U.S. Free Trade Agreement preferences. Too bad, this is not the case now in NAFTA, as explained. *See* Asian Development Bank, *supra* note 51, at 52.

of cotton or man-made fibers.” Such a rule is typically used as usual for protectionist purposes,<sup>144</sup> i.e. to protect the North American materials producers from foreign competition (mainly Asian) by encouraging the regional apparel producers to source the materials needed for producing apparels from North America instead of Asia<sup>145</sup> (where efficient producers are)...<sup>146</sup>

Pursuant to the NAFTA triple transformation rule, with an exception to the seven percent de minimis provided under the agreement, all of the apparel production processes must take place regionally, i.e. in North America. It is as if a 100% RVC requirement is imposed on apparel products.<sup>147</sup>

“Rules of origin should be objective, understandable and predictable.”<sup>148</sup> In addition to the fact that the triple transformation rule is stringent, it is exceedingly complicated.<sup>149</sup> Consequently, it makes it hard for many traders and producers to grasp, and comply with it, especially those who are trying to run a production firm and who are involved in trade for the first time.

As in the AGOA, the U.S. clothing industry was the one that pressed for the application of the triple transformation rule in the NAFTA.<sup>150</sup> One of the primary reasons for this<sup>151</sup> was to provide the U.S. clothing production firms that relocated to Mexico (to take advantage of the inexpensive labor)<sup>152</sup> with U.S. materials without giving them the option to use instead imported

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<sup>144</sup> See Mariana C. Silveira, *Rules of Origin in International Treaties: Comparative Study of NAFTA and MERCOSUR, and a General Overview of the European Union 56* (1999) (LL.M. Thesis, University of Arizona), available at <http://www.natlaw.com/pubs/tesmari.htm>.

<sup>145</sup> Stefano Inama, *Rules of Origin in International Trade* 18, ASIAN DEV. BANK, 2004, available at <http://www.adb.org/Documents/Events/2004/Intensive-Rules-Origin/text-inama-1.pdf>.

<sup>146</sup> Rupa Duttgupta & Arvind Panagariya, *Free Trade Areas and Rules of Origin: Economics and Politics* 26 (Int’l Monetary Fund, IMF Working Paper No. 03/229, Nov. 2003).

<sup>147</sup> *Id.*

<sup>148</sup> Agreement on Rules of Origin, Uruguay, Round of Multilateral Trade Negotiations, Article 9(c) (Sept. 20, 1986) (Uruguay).

<sup>149</sup> Jones, *supra* note 139, at 7.

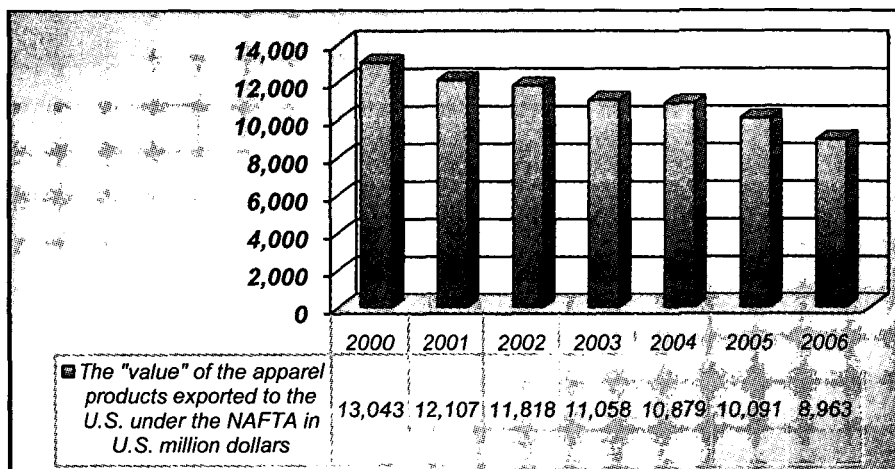
<sup>150</sup> Harilal, *supra* note 24, at 20.

<sup>151</sup> The word “one” is mentioned because avoiding trade deflection could be another reason for the application of the triple transformation rule. However, such reason is usually used as an excuse for the application of stringent RoO.

<sup>152</sup> See Michael G. Wilson, *The North American Free Trade Agreement: Gauging Its Impact on the U.S. Economy*, Heritage Lecture, Sept. 27, 1993, <http://www.heritage.org/Research/TradeandForeignAid/HL468.cfm>.

Asian materials when producing apparel needed to be exported under the NAFTA.<sup>153</sup>

According to the statistics shown by the following chart, the stringency of the imposed NAFTA triple transformation rule is reflected in a decline that is apparent in the value of the apparel products exported to the U.S. under the NAFTA beginning from 2000 until 2006.



Source: Author's calculations based on data from Ahmad (2007).<sup>154</sup>

Unless flexible NAFTA RoO are going to be imposed on apparel products, the value of the latter that are imported to the U.S. under the agreement will keep on declining year by year. Hence, the imposition of flexible NAFTA RoO on apparel products is needed in order to increase the intra-NAFTA trade in apparel.

#### 4. Article 303 of the NAFTA vs. Article XXIV of the GATT

The complexity and the vigorous protectionism of the NAFTA are not only reflected in its stringent RoO, but also in another module.

"The purpose of . . . a free-trade area should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories"<sup>155</sup>. Such GATT principles have been violated by Article 303 (Restrictions on Drawback and Duty Deferral Programs) of the NAFTA.

<sup>153</sup> M. ANGELES VILLARREAL, INDUSTRY TRADE EFFECTS RELATED TO NAFTA CRS REPORT FOR CONGRESS RL31386 at 8 (2002).

<sup>154</sup> Ahmed, *supra* note 48, at 17.

<sup>155</sup> General Agreement on Tariffs and Trade, *supra* note 35.



Before stating how the GATT principles have been violated, it is worth mentioning the meaning of the terms “*duty drawback*” and “*duty deferral*.” The former is the reimbursement of customs duties paid upon the importation of inputs that will be used in producing a finished product that is going to be exported. The latter takes place when the payment of customs duties upon the importation of inputs is put off until the finished product that is produced by using the inputs becomes ready to be used up locally. “Alternatively, if the finished products are exported, no import duties are ever paid”<sup>156</sup> which is regarded then as a trade facilitation for both of the importers and the exporters.

According to Article 303 of the NAFTA, none of the NAFTA contracting parties are allowed to give back, forgo or lower its “customs duties” that are payable upon the importation of a third country’s materials, if such materials are going to be used in producing a final product that will be exported to any of the rest NAFTA contracting parties under the NAFTA preferences. Therefore, third countries’ suppliers, especially those who used to provide any of the NAFTA contracting parties with fine and inexpensive materials, are not taking advantages because the article<sup>157</sup> has been discouraging the North American importers to import materials from external sources of supply. In addition, taking away the duty drawback benefit from regional importers is taking away a regional trade facilitation tool. This caused hence article 303 to become a barrier to the trade of third countries with the region, to become an anti-intra-regional trade facilitation mean and to become consequently in breach of the previously mentioned GATT article principles.

Basically, Article 303 aims at preventing Mexico from providing programs that facilitate the importation of the inputs its producers need when producing a final product that is desired to be exported to Canada and/or the U.S. under the NAFTA preferences. Hereby, Article 303 became a controversial issue. On one hand, it might be aiming at encouraging the Mexican final goods producers to use domestic inputs when producing the finished products they need to export under the NAFTA. On the other hand, it might be aiming also at preventing “unfair competition” from being triggered between the Mexican producers who benefit from the drawback and duty deferral programs and those of the rest NAFTA parties who do not benefit as the former<sup>158</sup> when producing the same goods.<sup>159</sup>

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<sup>156</sup> Carlos Angulo-Parra, Edmundo Elias-Fernandez & Carol S. Osmond, *Mexico: Maquiladoras and NAFTA Beyond Year 2000*, NAT’L LAW CTR. FOR INTER-AM. FREE TRADE, (1996), <http://www.natlaw.com/treaties/spmxcu4.htm>.

<sup>157</sup> Edith H. Castañeda, *Rules of Origin as Obstacles to International Trade: The Case of NAFTA 19* (N. Am. Consortium on Legal Educ. 2008), available at <http://www.nacle.org/students/student-paper-competition/2008-winners.html>.

<sup>158</sup> For example, the U.S. does not have any “program” that is tantamount to Maquiladora (which is a program that will be illustrated next). See *id.* at 26.

The first mentioned aim is not an excuse because why would a country's producer need to import inputs from an outsider (or external) supplier, if she can source in its country efficient inputs?

The second specified aim, of preventing unfair competition, also does not make sense. One plausible solution to overcome the so-called "unfair competition" was to have applied duty drawback rules in all of the relevant North American territories and thus make things easier for all of the regional importers.

Even if the intention of Article 303 is to realize the two mentioned aims, the consequences of doing so are harsh on third countries since their exportation to NAFTA parties - primarily Mexico - is hindered. For instance, Maquiladora (or Maquila)<sup>160</sup> is a Mexican firm that is regarded, according to the NAFTA, as a duty deferral program.<sup>161</sup> Maquiladora imported third countries' inputs "duty free" in order to piece them together and use them to produce or fix up a final product that will typically be exported.<sup>162</sup> On January 1, 2001, the importation of third countries' inputs duty-free under Maquiladora and using them in producing a final product that is aimed to be exported to the U.S. and/or Canada under the NAFTA came to an end by the agreement.<sup>163</sup> Whatever the case may be, inputs imported from third countries under Maquiladora are allowed to be used in producing a finished product that will be sold domestically in Mexico.<sup>164</sup>

The consequences of Article 303 of the NAFTA on Maquiladora were severe. In 2001, about 253 Maquiladoras were closed. Moreover, 250,000 workers lost their positions.<sup>165</sup> According to Sargent, "NAFTA article 303, and modifications in various international agreements have all contributed to the loss of over a quarter of a million Maquiladora jobs."<sup>166</sup>

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<sup>159</sup> *Id.* at 19-20.

<sup>160</sup> It is known also as the Border Industrialization Program. Maquila Properties, Inc., [http://www.maquilaproperties.com/maquila\\_overview1998.html](http://www.maquilaproperties.com/maquila_overview1998.html) (last visited Mar. 25, 2009).

<sup>161</sup> Angulo-Parra, *supra* note 156, at 678.

<sup>162</sup> Univ. of Delaware, <http://www.udel.edu/leipzig/texts2/vox128.htm> (last visited Apr. 1, 2009).

<sup>163</sup> Jesus Cañas & Roberto Coronado, *Maquiladora Industry: Past, Present and Future*, 2 EL PASO BUS. FRONTIER (2002), available at <http://www.dallasfed.org/research/busfront/bus0202.html>. See also Jim Gerber, *Whither the Maquiladora? A Look at the Growth Prospects for the Industry After 2001* 2 (San Diego Dialogue, Working Paper #E-99-1, 1999), available at <http://www.sandiegodialogue.org/pdfs/Maquila%20doc.pdf>.

<sup>164</sup> PATRICK J. KELLY, MEXICO MAQUILADORAS AND NAFTA (2001), [http://www.fredlaw.com/articles/international/intl\\_0103\\_pjk.html](http://www.fredlaw.com/articles/international/intl_0103_pjk.html).

<sup>165</sup> Villarreal, *supra* note 153, at 13.

<sup>166</sup> John Sargent, *Charter Evolution in Maquiladoras: A Case Study of Reynosa, Tamaulipas* 1 (The Univ. of Texas-Pan Am., Ctr. of Border Econ. Studies,

“No nation was ever ruined by trade”<sup>167</sup> - that is because trade is a gateway to welfare. The more regional parties facilitate trade, the more they witness a growth in their welfare, and vice versa. However, the use of stringent RoOs as protectionist apparatuses in the NAFTA region is hindering the achievement of economic welfare. This is clarified in many product sectors, as formerly indicated. For the aforementioned reasons, it is thus necessary to impose neutral and flexible RoO in the NAFTA in an effort to facilitate trade between its constituent parties and to overcome the complexities most of the North American producers and traders are facing.

### *E. How to Get Rid Of All Imposed Protectionist RoO*

As the previous illustrations demonstrate, RoOs have been used as protectionist apparatuses in both preferential and non-preferential trade schemes.

The noncompliance of WTO member states with *status quo* and the application of RoO that suit the interests and protect the susceptible goods of the countries that designed them reflect the usage of the rules as protectionist devices. This makes things complex for traders and producers all over the world in that it: (1) increases the number of international trade disputes; (2) reduces the utilization proportions of preferences in regional trade areas; and (3) undermines global competition. As a direct result, consumers worldwide are left with few choices and international trade (intra-regional and trade with third countries) is hindered. These unintended consequences go against many of the GATT and the WTO ARoO principles. Finally, as exemplified in Lesotho, the imposition of flexible RoO has been proven to spread welfare.

The employment of RoO as protectionist devices exists in many preferential and non-preferential trade regimes. This section examines the most popular agreements and systems in order to prove the issue of protectionism. The U.S. – India dispute, the EU GSP, The SADC, The AGOA and the NAFTA are just models used to clarify how the imposition of stringent RoO, as the double transformation rule, and too stringent ones, as the triple transformation rule, has been used to pursue protectionist purposes..

Based on the previous analysis and clarifications, the following solutions are suggested to be carried out in order to prevent the application of any protectionist rule of origin:

- Calculating the production capability of RTAs contracting parties, by gathering statistics and information about their established capacities

and by knowing to what range they use such capacities, and imposing accordingly the RTAs RoO.

- Or the harmonization of preferential and non-preferential RoO.

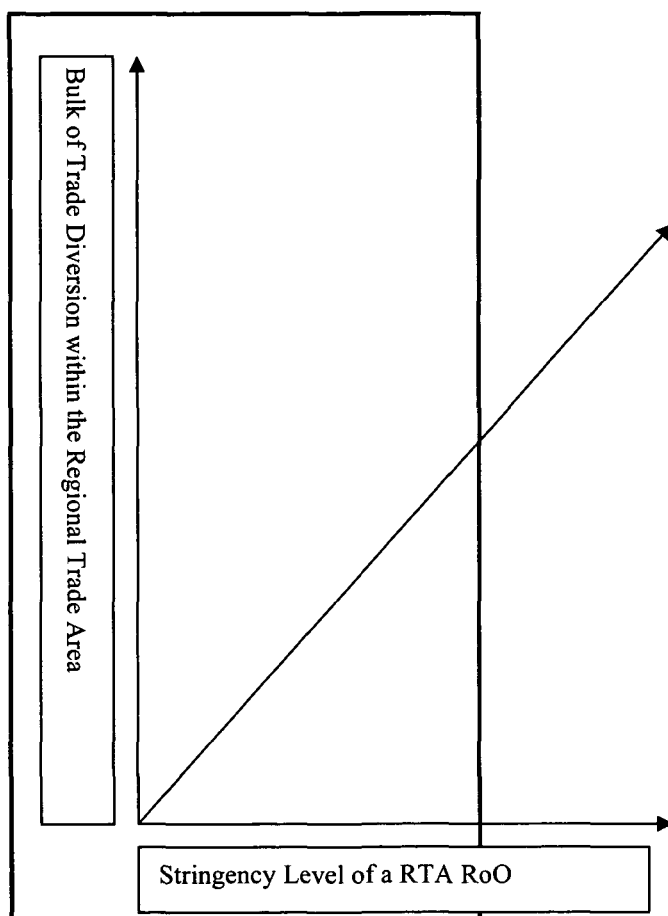
Complying with the second suggested solution is the most efficient way to avoid the issue of using RoO as protectionist instruments.<sup>168</sup> Doing so would: (1) cease the freedom of countries to use RoO in a disguised way to protect their own national interests and susceptible goods; (2) ensure the objectivity, predictability and transparency of RoO; (3) eliminate the variation in such rules across agreements and countries; (4) reduce the number of international trade disputes; (5) increase the utilization proportions of preferences in regional trade areas; (6) foster a global environment of fair competition; and (7) provide consumers all over the world with choices. As a result, international trade would be facilitated and welfare would spread worldwide. Under this strategy, the aims of the GATT and the WTO ARoO fundamentals would successfully be realized without being breached.

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<sup>168</sup> See the harmonization issue in part D.

### III. ROO AS TRIGGERS TO TRADE DIVERSION

“[T]he higher the threshold established in the rules of origin, the greater the chance that trade diversion will take place.”<sup>169</sup>



Source: Author's analysis.

Trade diversion transpires when a regional importer diverts its importation of goods from an efficient outsider source of supply to an inefficient internal one (source of supply located inside of the regional trade

<sup>169</sup> Anne O. Krueger, *Free Trade Agreements as Protectionist Devices: Rules of Origin*, in *TRADE, THEORY, AND ECONOMETRICS: ESSAYS IN HONOR OF JOHN C. CHIPMAN* 91-101 (James R. Melvin et al. eds., 1999) (citing WILLIAM H. COOPER, *FREE TRADE AGREEMENTS: IMPACT ON U.S. TRADE AND IMPLICATIONS FOR U.S. TRADE POLICY* 8 (2008)).

area). As such, trade diversion negatively affects “global efficiency” in that it widens the “production” of inefficient regional trade area “producers” and shrinks the production of efficient third countries producers.<sup>170</sup> Consequently, the imposition of trade-diverting RoO negatively affects global efficiency and begs the question: How can RoO divert trade?

The imposition of stringent RoO in preferential trade regimes results in trade diversion when a regional final goods producer alters its importation of intermediate goods from an efficient outsider intermediate goods supplier to a less efficient internal one in order to comply with the RTA stringent RoO...

It must also be noted that trade diversion does not only happen because of the imposition of stringent RTA RoO; it also takes place as a result to the imposition of trade barriers, such as a country’s “external tariffs”<sup>171</sup> (illustrated later in this part).

#### A. *Trade-diverting RoO and a Double Loss in Welfare vs. Trade Creation and GATT Principles*

“Trade creates jobs and lifts people out of poverty”;<sup>172</sup> but, this raises the question: how is trade created? Trade is created regionally when the formation of a RTA causes a regional importer to shift its importation of goods to an efficient internal source of supply from a less efficient external one. Trade creation is the opposite of trade diversion. It boosts welfare regionally once it takes place there subsequent to the formation of a RTA.

The number of any FTA or CU members is of a considerable relation with trade diversion and trade creation. If a large number of countries become members of a FTA or a CU, there is a greater chance of the existence of efficient goods producers within the regional trade area leading regionally somewhat to trade creation and to the avoidance of trade diversion, and vice versa.<sup>173</sup> For these reasons, if countries all over the world are members in a worldwide FTA, trade diversion will never find a way to exist. In that case, imagining of course the formation of a global CU would be ridiculous because if countries across the globe are all members in the CU, to which country’s goods the common global external tariff would be applied?

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<sup>170</sup> Robert Z. Lawrence, *Regionalism and the WTO: Should the Rules be Changed?*, in THE WORLD TRADING SYSTEM: CHALLENGES AHEAD 52 (Jeffrey J. Schott ed., 1996), available at

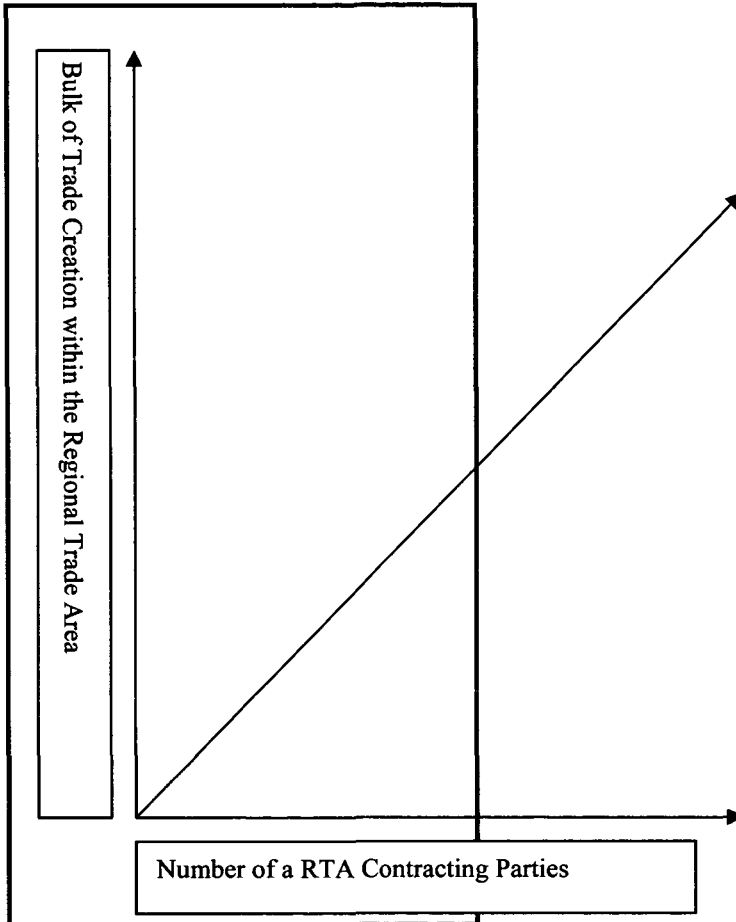
[http://www.petersoninstitute.org/publications/chapters\\_preview/66/3iie2350.pdf](http://www.petersoninstitute.org/publications/chapters_preview/66/3iie2350.pdf). See also Asian Development Bank, *supra* note 51, at 9.

<sup>171</sup> See Krueger, *supra* note 33, at 4.

<sup>172</sup> The attributed quote belongs to Dennis Hastert. BrainyQuote, [http://www.brainyquote.com/quotes/authors/d/dennis\\_hastert\\_2.html](http://www.brainyquote.com/quotes/authors/d/dennis_hastert_2.html) (last visited Mar. 25, 2009).

<sup>173</sup> North Carolina Cooperative Extension, <http://www.ces.ncsu.edu/depts/agecon/trade/eight.html> (last visited Apr. 3, 2009).

The formation of a “global” FTA might best be achieved by establishing a simple single FTA. The more sizable countries join such FTA, the more third countries will yearn to become members. This desire will ultimately lead to the formation of a global FTA. As a result, trade will flourish all over the world and welfare will spread worldwide.<sup>174</sup>



Source: Author's analysis.

Based on the all of the pre-indicated arguments of this part, the imposition of trade-diverting RoO in a RTA negatively affects the “economic welfare”<sup>175</sup> of third countries and does not facilitate their trade with the

<sup>174</sup> Soamiely Andriamananjara, Remarks at the PECC Trade Forum Meetings at the Institute for International Economics 3 (Apr. 22, 2003), *available at* [http://www.pecc.org/publications/papers/trade-papers/1\\_SII/6-andriamananjara.PDF](http://www.pecc.org/publications/papers/trade-papers/1_SII/6-andriamananjara.PDF).

<sup>175</sup> Cooper, *supra* note 169, at 8.

regional trade area since it obstructs efficient third countries' suppliers from providing the regional final goods producers with intermediate products, unless any of the latter decide to forgo the RTA preferences, and trade regionally on MFN grounds to maintain its importation of intermediate goods from the efficient outsider suppliers. On the other hand, applying the trade-diverting RoO in a RTA does not facilitate intra-regional trade, and further lessens the economic welfare of the RTA contracting parties since the rules induce the regional final goods producers to source regionally costly inputs when they could have sourced cheaper ones from outside suppliers instead. Hereby, the application of trade-diverting RoO in preferential trade regimes violates the principles of article XXIV (4) of the GATT 1947<sup>176</sup> because pursuant to such article paragraph, the formation of RTAs "should be to facilitate trade between the constituent territories and not to raise barriers to the trade of other contracting parties with such territories."<sup>177</sup>

#### B. *The Relation Between the Imposition of Protectionist RoO and Trade Diversion*

The indicated example in the previous part (RoO as protectionist apparatuses) concerning ketchup is an example of an occurred case of trade diversion, where the imposition of the stringent NAFTA rule of origin for ketchup aims at driving North American ketchup producers to source the needed tomato paste from *protected* Mexican tomato paste producers, rather than from the more efficient paste producers of Chile.<sup>178</sup> That is why there is a quiet relation between using RoO as *protectionist* devices and the occurrence of trade diversion.

Since the imposition of a protectionist rule of origin in a RTA endeavors to protect a regional intermediate goods supplier from competition from a more efficient outsider supplier by causing a shift in the regional importation of intermediate goods to the former from the latter, all RTAs protectionist RoO are trade-diverting, and thus negatively affecting the global efficiency. Many examples other than the mentioned ketchup rule of origin clarify the absolute relation between the imposition of stringent, protectionist RoO and the occurrence of trade diversion. The following subparts illustrate additional examples.

##### 1. *North America vs. Asia*

Again regarding NAFTA and its stringent, protectionist, triple transformation rule of origin is imposed to mainly induce the North American apparel producers to source the materials needed for producing apparels from

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<sup>176</sup> See Vermulst, *supra* note 6, at 16.

<sup>177</sup> General Agreement on Tariffs and Trade, *supra* note 35, art. XXIV(4).

<sup>178</sup> Brenton, *supra* note 128, at 20.



North America instead of Asia.<sup>179</sup> Once the North American apparel producers source the materials they need regionally – rather than from Asia, where apparel materials providers are more efficient – trade diversion takes place.

In point of fact, a diversion of North American apparel imports, following the formation of the NAFTA, from efficient Asian suppliers<sup>180</sup> to Mexico took place, which led to a reduction in the Chinese and the Indian apparel exports to the U.S. and Canada. Consequently, Mexico acquired a considerable “market share” in both Canada and the U.S. concerning its apparel “exports” to the markets of both of the latter NAFTA members.<sup>181</sup> This explicates the role of the imposed triple transformation rule in protecting North American apparel materials producers and diverting trade to them because of their being less efficient than those of Asia (mainly Chinese and Indian producers).

Not only Asian countries, but also Caribbean ones have declared that the NAFTA stringent RoO imposed on the apparels and automobiles sectors are causing trade diversion.<sup>182</sup>

## 2. Mexico vs. the Caribbean and Central America

During the parley of the NAFTA in 1990, many non-NAFTA members indicated that a diversion of trade to the NAFTA parties from the former would take place, although plenty of the third countries’ goods are more efficient than those of the NAFTA members. In addition, even Mexico clarified that the trade diversion that could be caused by the NAFTA is of a crucial significance since the substitution of the Mexican importation of cheap goods from non-NAFTA members by the Mexican importation of costly ones

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<sup>179</sup> Inama, *supra* note 145, at 18. Richard Eckaus of M.I.T. and Robert Scott of the University of Maryland proved also that trade diversion has taken place in North America concerning the apparels sector subsequent to the formation of the NAFTA (citing Arvind Panagariya, *The Regionalism Debate: An Overview*, 22 WORLD ECON. 477-511 (1999)).

<sup>180</sup> WORLD BANK, NAFTA AND TRADE FLOWS OF NONMEMBER COUNTRIES 16 (2003), <http://ctrc.sice.oas.org/geograph/north/NAFTA%20Lessons%20Chapter%206%20Trade%20Diversion.pdf>.

<sup>181</sup> T.N. Srinivasan, Presentation at the Asian Economic Outlook Workshop 9-10 (Nov. 2001), *available at* <http://www.econ.yale.edu/~srinivas/PrefTradeAgreements.pdf>.

<sup>182</sup> GEORGE HOLLIDAY, CRS REPORT FOR CONGRESS: REGIONAL TRADE AGREEMENTS 13 (1997), *available at* [http://assets.opencrs.com/rpts/97-663\\_19971212.pdf](http://assets.opencrs.com/rpts/97-663_19971212.pdf).

under the NAFTA from the U.S. and/or Canada would lead to forfeiture in the Mexican financial takings.<sup>183</sup>

Subsequent to the formation of the NAFTA, the aggregate clothing exports of Caribbean and Central American countries to North America became less than that of Mexico to the rest of its NAFTA contracting parties.<sup>184</sup>

According to the current sources of information, the NAFTA preferential treatment is not accountable for the regional shift of clothing importation from Caribbean and Central American countries to Mexico. This proves that the imposition of the NAFTA stringent apparel RoO was possibly, to a considerable extent, the cause of the specified diversion in the North American Free Trade Area.<sup>185</sup>

The following chart compares the allocations of Mexico, Central America and the CARICOM<sup>186</sup> in the North American Free Trade Area total apparel imports prior and subsequent to the formation of the NAFTA until 2001.

Pursuant to the statistics included in the chart, trade diversion did take place in the North American Free Trade Area because the aggregate Mexican clothing exports to the region before the formation of the NAFTA was less than that of the Central American and Caribbean countries, and contrary to what the situation came to be after the formation of the agreement, where the overall Mexican clothing exports to the region became higher than that of its two aforementioned rivals.

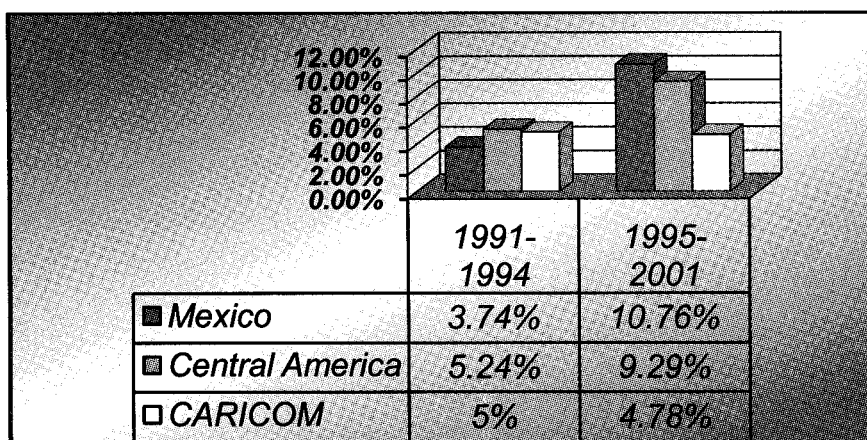
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<sup>183</sup> DANIEL LEDERMAN, WILLIAM F. MALONEY & LUIS SERVEN, LESSONS FROM NAFTA FOR LATIN AMERICA AND THE CARIBBEAN COUNTRIES: A SUMMARY OF RESEARCH FINDINGS 16 (2003), *available at* [http://lnweb90.worldbank.org/CAW/Cawdoclib.nsf/0/BC1B10FC17938F3B85256C5E00691B00/\\$file/NAFTA+Introduction+\\_Executive+Summary+\\_P077128.pdf](http://lnweb90.worldbank.org/CAW/Cawdoclib.nsf/0/BC1B10FC17938F3B85256C5E00691B00/$file/NAFTA+Introduction+_Executive+Summary+_P077128.pdf).

<sup>184</sup> *Id.* at 17.

<sup>185</sup> *Id.* at 16. It is to be noted that, the formation of RTAs, the imposition of external tariffs to only non-RTAs members, and the accordance of the RTAs preferences to only the RTA parties could lead to trade diversion, as well as the imposition stringent RoO in RTAs. This will be illustrated later in this part of the paper.

<sup>186</sup> The CARICOM consists of fifteen member states. They are; Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, Saint Lucia, St. Kitts and Nevis, St. Vincent and the Grenadines, Suriname and Trinidad and Tobago. There is also the CARICOM Single Market. More information about the CARICOM member states and the CARICOM Single Market is available at Caribbean Community Secretariat website. Caribbean Community Secretariat, [http://www.caricom.org/jsp/community/member\\_states.jsp?menu=community](http://www.caricom.org/jsp/community/member_states.jsp?menu=community) (last visited Mar. 25, 2009).



Source: Author's calculations based on The World Bank (2003).

The CBTPA (or the CBI<sup>187</sup>) of 2000<sup>188</sup> allows many “Caribbean, and Central and South American countries”<sup>189</sup> to export apparel to the U.S. duty and quota free.<sup>190</sup> However, to enjoy such preferences, the apparel must be produced in compliance with the CBTPA rule of origin for apparel before being exported to the U.S.<sup>191</sup>

According to the stated origin rule, the apparel has to be “cut in a CBI country from U.S. fabric made from U.S. yarn and assembled there with U.S. thread.”<sup>192</sup> Therefore, the rule is of a triple transformation nature as that

<sup>187</sup> INT’L TRADE ADMIN., U.S. DEP’T OF COMMERCE, GUIDE TO THE CARIBBEAN BASIN INITIATIVE 1 (2000), *available at* <http://trade.gov/media/Publications/pdf/cbi2000.pdf>.

<sup>188</sup> The CBTPA was the CBERA in 1983. See J. F. HORNBECK, U.S. DEP’T OF STATE, U.S. TRADE POLICY AND THE CARIBBEAN: FROM TRADE PREFERENCES TO FREE TRADE AGREEMENTS (2007), *available at* <http://fpc.state.gov/documents/organization/82982.pdf>. More information is also available at Caribbean Basin Trade Partnership Act (CBTPA). American Apparel & Footwear Association, <http://www.apparel and footwear.org/LegislativeTradeNews/CBTPA.asp#Frequent%20Questions> (last visited Mar. 25, 2009).

<sup>189</sup> WORLD BANK, *supra* note 180, at 36. The number of beneficiaries is 24: Antigua and Barbuda, Aruba, Bahamas, Barbados, Belize, Costa Rica, Dominica, Dominican Republic, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Montserrat, Netherlands Antilles, Nicaragua, Panama, St. Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Trinidad and Tobago, and British Virgin Islands. U.S. CUSTOMS SERV., WHAT EVERY MEMBER OF THE TRADE COMMUNITY SHOULD KNOW ABOUT: THE U.S.-CARIBBEAN BASIN TRADE PARTNERSHIP ACT 1 (2001), *available at* <http://www.apparel and footwear.org/pdf/cbtpaguide.pdf>.

<sup>190</sup> WORLD BANK, *supra* note 180, at 36.

<sup>191</sup> *See id.*

<sup>192</sup> NATHAN ASSOCIATES INC., RULES OF ORIGIN: FREQUENTLY ASKED QUESTIONS 3 (2003), *available at* [http://pdf.dec.org/pdf\\_docs/PNACS144.pdf](http://pdf.dec.org/pdf_docs/PNACS144.pdf). *See also*

of the NAFTA and the AGOA. This reflects the extent to which the U.S. apparel industry lobbies for the application of the triple transformation rule of origin in the autonomous and contractual trade agreements to which the U.S. is a party. However, a deeper meditation on the CBTPA triple transformation rule will prove that it is more restrictive than that of the NAFTA. Even though the latter is also restrictive, it permits sourcing the yarn from any NAFTA contracting party, "not only the U.S."<sup>193</sup> As a result, a diversion of North American apparel imports from the CBI countries to Mexico took place, taking into consideration that Caribbean apparel "producers" are "more efficient" than those of Mexico.<sup>194</sup>

The next chart shows the "percent of apparel exports to the U.S." in specific years under the "CBTPA and NAFTA preferences."<sup>195</sup>

Although the Caribbean apparel producers are more efficient than those of Mexico, the latter's apparel exports to the U.S. were increasingly more than those of the CBI countries (a case of trade diversion).

It is to be noted that although the CBTPA was enacted in 2000, the year 1995 is included in the chart to represent what the situation was like during the enforcement period of the CBERA program, which became the CBTPA in 2000.

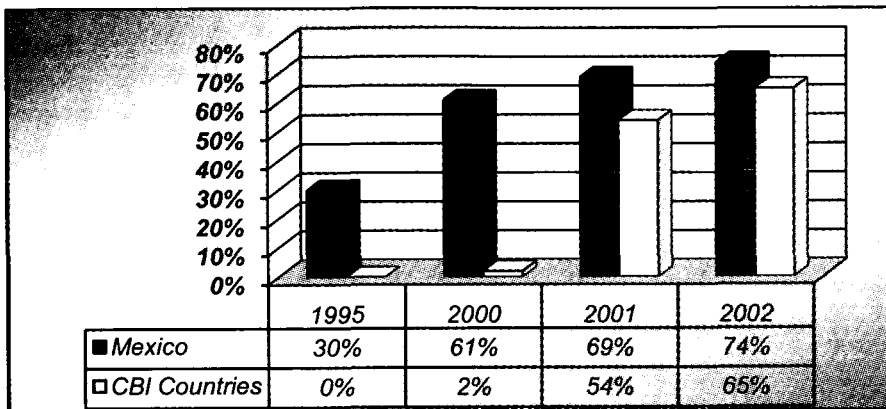
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SANDLER, TRAVIS & AND ROSENBERG, P.A., CARIBBEAN/SUB-SAHARAN AFRICA TRADE BILL PASSES IN HOUSE (2000), *available at* <http://www.apparelandfootwear.org/pdf/cbi.pdf>.

<sup>193</sup> WORLD BANK, *supra* note 180, at 36.

<sup>194</sup> HOLLIDAY, *supra* note 182, at 9; *see also* WORLD BANK, *supra* note 180, at 16. Dean also indicated that the NAFTA, following its formation in 1994, reduced the impacts of the CBERA program by causing trade and investment diversion. *See* JUDITH M. DEAN, U.S. INT'L TRADE COMM'N, DO PREFERENTIAL TRADE AGREEMENTS PROMOTE GROWTH? AN EVALUATION OF THE CARIBBEAN BASIN ECONOMIC RECOVERY ACT 4 (2002), *available at* [http://www.usitc.gov/publications/332/working\\_papers/ec0207a.pdf](http://www.usitc.gov/publications/332/working_papers/ec0207a.pdf).

<sup>195</sup> WORLD BANK, *supra* note 180, at 36.



Source: Author's calculations based on World Bank (2003).

If the imposition of the RoO in the CBTPA were more flexible than that in the NAFTA, no trade diversion would have occurred. However, implementing this would have been unfair to Mexican apparel producers because they would have faced two kinds of obstacles. The first is complying with the stringently imposed NAFTA triple transformation rule of origin and the second is the possible occurrence of a great flow in the amount of CBI countries' apparel exports to the U.S. that would have been too competitive for the Mexican apparel producers to handle. That is why harmonizing the RoO as implemented in the NAFTA and the CBTPA, even in the sectors of sensitive products, is a simple, fair solution that could have overcome the illustrated trade diversion problem. If it was applied, for example, by imposing the triple transformation rule of origin in the CBTPA in a manner similar to the way the rule is imposed in the NAFTA, where yarns could be allowed to be sourced from any CBTPA contracting party rather than just the U.S., the problem could have been avoided.<sup>196</sup>

If the country of an importer is a member of two RTAs and both of their imposed RoO are all, or even in specific sectors, harmonized, the exportation of goods from the most efficient supplier inside either of the two regional trade areas to the importer will take place. Accordingly, if the CBTPA- and the NAFTA-imposed apparel RoO were harmonized, the Caribbean apparel exports to the U.S. could have been increased above those of Mexico to the U.S. since Caribbean apparel producers are more efficient than those of Mexico. Consequently, no trade diversion would have occurred and the Mexican apparel producers could have had the ability to compete fairly with those of the CBI countries with regard to exportation of apparel to the U.S.

<sup>196</sup> It would have been much better, of course, if a more flexible rule of origin was imposed on apparel products in both of the NAFTA and the CBTPA.

### 3. *The EU vs. China*

As clarified in the previous part, the imposition of the double transformation rule of origin in the EU preferential trade agreements aims mainly at encouraging the regional apparel producers to source the materials they need from EU suppliers rather than from more efficient outsider providers, such as those of China. Thus, trade diversion has been taking place because of the EU's practice of imposing the stringent, protectionist, trade-diverting double transformation rule.<sup>197</sup>

#### C. *Trade Diversion and the Transshipment of Goods*

##### 1. *FTAs*

The transshipment (or trade deflection) of goods via a FTA member imposing the least external MFN tariff onto another member could happen, if lax RoO are imposed in the FTA. That is why stringent RoO are usually imposed in FTAs: to prevent the mentioned problem from taking place, leading, unfortunately, to a case of trade diversion. Nevertheless, if the FTA contracting parties lower their external MFN tariffs, their incentives to impose stringent RoO in the FTA would be undermined because following the MFN tariff reductions, transshippers would not be induced to transship their goods from a contracting party to the FTA imposing a liberal external MFN tariff to another party imposing a liberal one as well. As a result, trade diversion that happens because of the imposition of stringent RTA RoO would not find a way to occur within the free trade area since the FTA RoO would be flexible, which would, to a considerable extent, allow the regional finished goods producers to source the inputs they need from the most efficient third countries' intermediate goods suppliers; to produce thereof final products that could be exported regionally under the FTA preferences.<sup>198</sup>

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<sup>197</sup> Brenton, *supra* note 56, at 14-15.

<sup>198</sup> See Asian Development Bank, *supra* note 51, at 5. It is clarified there "that countries forming free trade areas should be required to reduce MFN tariff rates to offset" the "tendency" of trade diversion.

**The Simple FTAs Anti-Trade Diversion and Pro-welfare spreading Equation**

Liberalizing the external MFN tariff of the FTAs each contracting party  
(→\* A reduced inducement for transshipment → The imposition of flexible FTAs RoO) = A confrontation<sup>199</sup> to trade diversion + A propagation in welfare.

\* Stands for "would lead to."

In the previous indicated equation, the word "no" could have been written instead of the word "reduced," but this would not have been wise because even though the reduction of the external MFN tariffs of a FTA contracting parties *reduces* the incentives of transshippers to practice transshipment within the free trade area, the latter could, however, still transship goods via the FTA contracting party with the least external *lowered* MFN tariff to another party. A nice solution to avoid the occurrence of such a problem is to impose a common "external tariff" between the FTA contracting parties and to make such tariff reach the extent of the one least imposed by one of parties on the good.. Hence, the FTA will be changed to a CU.<sup>200</sup> Thus that proves that CUs are more efficient than FTAs in avoiding the problem of transshipment.

## 2. CUs

Eschewing trade deflection is not that complicated when it comes to a CU because, as formerly clarified, the imposition of the CU "common external tariff" plays a crucial role in preventing the deflection from happening within the region. However, the application of divergent "national trade rules," such as "anti-dumping and countervailing" duties, by each contracting party to a CU could lead to the occurrence of trade deflection. That is why harmonizing the national trade rules among the CUs contracting parties are required.<sup>201</sup>

Trade diversion does not only happen because of the imposition of stringent RTA RoO since it also takes place as a result of the imposition of trade barriers, such as a country's external tariffs. Here comes the part about lowering the external MFN tariffs of the RTAs member countries in countering trade diversion.

<sup>199</sup> The term "the elimination of" could have been written instead of the term "A confrontation of" but since trade diversion does not only take place because of the application of stringent RTA RoO, its total elimination cannot be accomplished if only RoO are taken into account. Accordingly, the term "A confrontation to" is written.

<sup>200</sup> Duttagupta, *supra* note 146, at 17-18.

<sup>201</sup> Ghoneim, *supra* note 49, at 598. See also Srinivasan, *supra* note 181, at 21 (for the harmonization of such policies).

*D. Encountering Trade Diversion by Reducing the External MFN Tariff and How to Kill Three Birds with One Stone:*

Supposedly, if RoO are not imposed in a FTA, the exportation of products to the region will be directed mainly to the member state with the smallest external tariff.<sup>202</sup>

According to Viner,<sup>203</sup> although the liberalization of tariffs among the member countries of a RTA expands trade between them by encouraging the regional sourcing of goods, it diverts trade from an external cheap source of supply to an internal expensive one.<sup>204</sup> In other words, following the formation of a RTA, the tariff liberalization among the RTA members makes the intra-regional trade less expensive than the extra-regional trade and outfits the regional sources of supply with “a price advantage.” This encourages the regional importers to source costly goods from inefficient internal suppliers and discourages them simultaneously from importing cheap ones from efficient outsider suppliers, which is contrary to the situation that occurred prior to the formation of the RTA, thus leading to a case of trade diversion.<sup>205</sup> Lowering the external MFN tariffs of the RTA’s contracting parties would give rise to “a more level playing field for intra- and extra-”RTA sources of supply,<sup>206</sup> and would help in *preserving* the trade of third countries with the RTA’s members, and would consequently confront trade diversion.<sup>207</sup>

By lessening the regional trade liberalization among RTA contracting parties step-by-step, the price advantage given to the regional suppliers gradually would cease to exist and the regional importers consequently would be induced to source from efficient outside sources of supply rather from the inefficient regional ones, probably leading to an outcome of no trade diversion. That is why “the less trade liberalization exists among constituents of a” RTA, “the less trade diversion will take place”<sup>208</sup> and vice versa, albeit the fact that liberalizing the regional trade by the elimination of some internal trade restrictions could create trade within the regional trade area.

<sup>202</sup> Duttagupta, *supra* note 146, at 17.

<sup>203</sup> JACOB VINER, THE CUSTOMS ISSUE (1950).

<sup>204</sup> Duttagupta, *supra* note 146, at 9-10.

<sup>205</sup> To see an example illustrating such point, see ROBERT LAWRENCE, REGIONALISM, MULTILATERALISM AND DEEPER INTEGRATION 24-25 (1996).

<sup>206</sup> Agustin Carstens, Speech at the 20th Annual General Meeting and Conference of the Pakistan Society of Development Economists (Jan. 12, 2005), available at <http://www.imf.org/external/np/speeches/2005/011205.htm>.

<sup>207</sup> Petros C. Mavroidis, *If I Don't Do It, Somebody Else Will* (or won't) *Testing the Compliance of Preferential Trade Agreements with the Multilateral Rules*, 40 J. WORLD TRADE 187, 191 (2006), available at [http://www.ycsg.yale.edu/focus/gta/if\\_i\\_dont.pdf](http://www.ycsg.yale.edu/focus/gta/if_i_dont.pdf).

<sup>208</sup> *Id.* at 39.



Seeing that the “removal” of certain internal barriers could lead to trade diversion and seeing that the removal of certain other internal ones could create trade, evading only the removal of the former has been recommended by some as a solution to face trade diversion and create trade within all regional trade areas. However, it is hard to determine which internal barriers are creating trade and which internal ones are diverting it. Besides, having the right to decide which barriers should be removed could be used as a protectionist tool by any of the RTAs contracting parties to protect “politically powerful producers from outside competition.”<sup>209</sup> Therefore, lowering the external MFN tariffs of the RTAs member countries is so far deemed to be the best solution to confront trade diversion.

Resting on the previous indicated arguments, the author came out with the following equation:

$\downarrow * \text{ The internal barriers between a RTA contracting parties} + \text{ The parties'}$ $\uparrow ** \text{ of high external MFN tariffs} = \text{Creating trade within the region} +$ $\text{Diverting trade to the region.}$
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\* Stands for lowering.

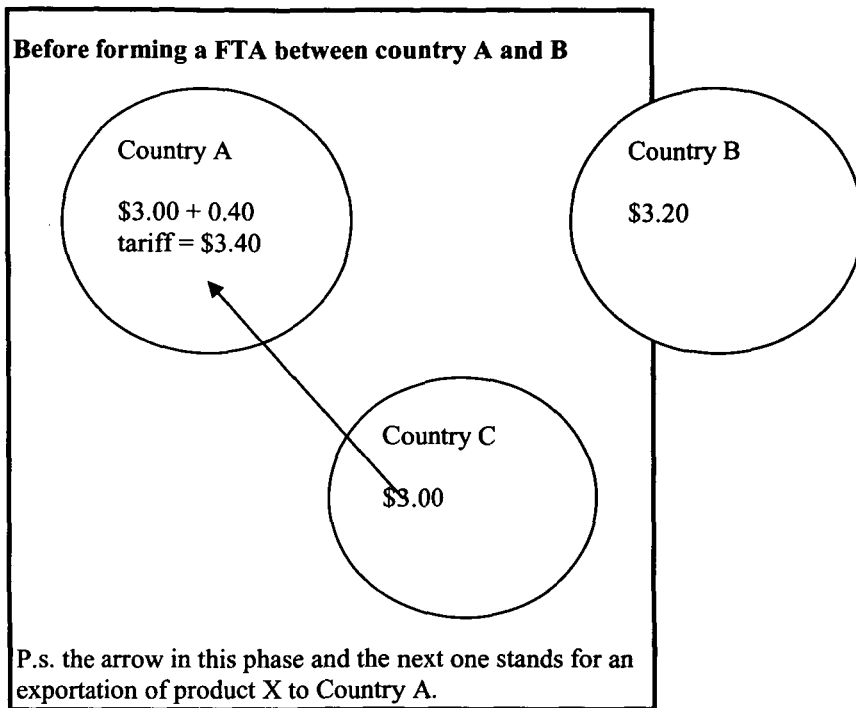
\*\* Stands for maintenance.

The next two figures suppose how trade diversion could take place because of forming a RTA.

By using three hypothetical countries: A, B and C, the figures compares between and shows a difference in the trade relationship between a FTA contracting party and an outsider source of supply prior and subsequent to the formation of the FTA....

Suppose that the importers of A used to import a product (say X) from C at a price of \$3.40 after paying a \$0.40 external MFN tariff. Suppose also, on the other hand, that the price of producing X in B is \$3.20. Hence, the importation of X from B, at a price of \$3.60 (including the payable \$0.40 tariff), would have been more costly for A's importers than that from C.

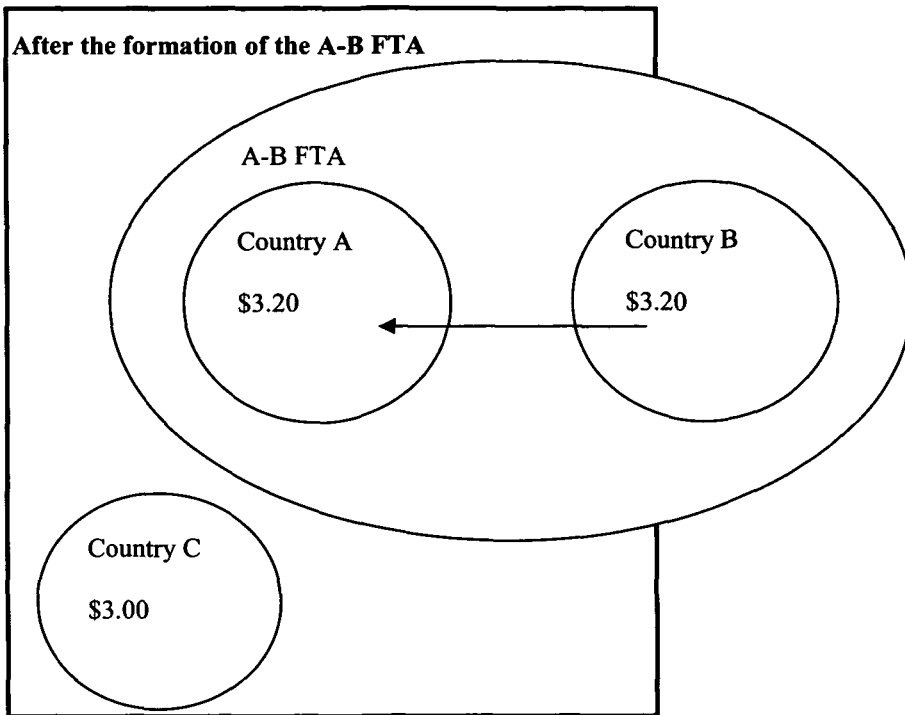
<sup>209</sup> HOLLIDAY, *supra* note 182, at 19. See also Asian Development Bank, *supra* note 51, at 21.



Source: Author's analysis.

Once a FTA between A and B (A-B FTA) is formed, the importers of A would source X from B under preferences—at a price of \$3.20—more cheaply than they would source it from C—at the price of \$3.40. Thereupon, forming the A-B FTA will divert the trade in X from a cheap source of supply C (producing X locally at the price of \$3.00) to a costly one B (producing X locally at the price of \$3.20). Hereby, trade diversion can be noticed by studying with which countries each contracting party to a RTA was and is practicing trade in goods prior and subsequent to the formation of the RTA.<sup>210</sup>

<sup>210</sup> Mavroidis, *supra* note 207, at 11.



Source: Author's analysis.

The UK used to import cheap lamb from New Zealand.<sup>211</sup> However, when the UK became a member state of the EU, it began to source lamb from a costly lamb internal supplier—France—because the EUCU “common external tariff” made the importation of lamb from New Zealand “more expensive” than the lamb from France.<sup>212</sup> The external tariff here was probably used for protectionist purposes: protecting the French lamb against competition from cheaper imported lamb from New Zealand.<sup>213</sup>

The UK could have had the ability to source cheap lamb from New Zealand, despite its entry into the EUCU, if the latter’s common external tariff was reduced to the extent that would not make the importation of lamb from New Zealand more expensive than that from France. Thus, this would lead to no trade diversion. That is why there is a necessity for the existence of a GATT “rule” urging RTAs to “leave outsiders at least as well off as they were

<sup>211</sup> PHILIP WHYTE, *NARROWING THE ATLANTIC: THE WAY FORWARD FOR EU-US TRADE AND INVESTMENT* (2009).

<sup>212</sup> *Id.* at 23-24

<sup>213</sup> See Carstens, *supra* note 206. Carstens mentions that countries may impose high external MFN tariffs for protectionist purposes.

before the agreement” by reducing the external MFN tariffs of the RTAs member countries to a degree that would not cause trade diversion.<sup>214</sup>

For some countries,<sup>215</sup> as in Africa, “South Asia and even Central and Eastern Europe,” the imposition of the external MFN tariff is considered to be a source of their income. However, if any of those countries is a member of a RTA and imposes a high external MFN tariff, the importers of such a country would be induced to source from within the regional trade area *under preferences*. Hence, the imposed external MFN tariff would lose its value as a source of income, and trade diversion would take place within the region,<sup>216</sup> so why the bother and imposing high external tariffs?

Hypothetically, if countries all over the world are assumed to be members of one FTA, the FTA preferences would be equally provided to all countries without discrimination, no external tariffs would be imposed (consequently the discriminatory imposition of tariffs would never happen), and even the application of preferential RoO would not be necessary anymore. As a result, none of the efficient producers would be an outsider. Thus, importers all over the world would be encouraged to import from any efficient producer, and inefficient producers would not find demands for their goods. This lack of demand would encourage inefficient producers to increase their efficiency and that would lead to a real increase in global efficiency.<sup>217</sup> Accordingly, trade diversion would never take place.

The author and Bergsten both suggest the formation of a global FTA.<sup>218</sup> A Heritage Foundation report also calls for the formation of a “Global Free Trade Association.”<sup>219</sup> In addition, Hindley stated that “the best rule of origin would be that which allows every trader to choose the origin that suits him best. That would typically be origin in the importing country, and would be tantamount to global free trade.”<sup>220</sup>

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<sup>214</sup> Lawrence, *supra* note 170, at 48.

<sup>215</sup> Arvind Panagariya, *The Regionalism Debate: An Overview*, in THE WORLD ECONOMY 477, 498-99 (1999) (“Africa, South Asia and even Central and Eastern Europe”).

<sup>216</sup> *Id.* at 499.

<sup>217</sup> It is to be noted then that sometimes the importation of goods from the outside sources of supply is reduced and shifted to the regional suppliers, not because of trade diversion, but because of the development in the efficiency of the regional suppliers.

<sup>218</sup> Fred C. Bergsten, *Open Regionalism* (Inst. for Int’l Economic, Working Paper No.97--3, 1997), available at <http://www.iie.com/publications/wp/wp.cfm?ResearchID=152>.

<sup>219</sup> John C. Hulsman & Aaron Schavey, *The Global Free Trade Association: A New Trade Agenda*, HERITAGE FOUND. BACKGROUNDER (2001), available at <http://www.heritage.org/research/tradeandforeignaid/bg1441.cfm>.

<sup>220</sup> Ghoneim, *supra* note 49, at 608.

The trade of a third country with a contracting party to a RTA can be maintained as well off as it was before the agreement if the former is allowed to become a member country of the RTA.<sup>221</sup> This, accordingly, would leave no room for the usage of the external MFN tariff as a protectionist device, would not allow for discrimination between the traded goods of internal and efficient outsider suppliers when it comes to the RTA preferences, would not hence keep the regional suppliers at a price advantage, would thus keep the regional importers on sourcing the cheap goods they used to source prior to the formation of the RTA, would consequently improve the efficiency of the internal suppliers, would as a result avoid the trade diversion that occurs following to and because of the formation of RTAs, would create trade within the regional trade area and would then spread welfare regionally. However, trade diversion could take place if other efficient external suppliers come into existence after the formation of the RTA. Possible solutions to this diversion crisis are the countries of such suppliers joining the RTA and/or lowering the external MFN tariffs of the RTA member countries.

Pursuant to Panagariya, “binding the external tariff and then bringing it down to the levels of the preferential tariff is” a great solution to overcome the problem of trade diversion within all regional trade areas.<sup>222</sup> For instance, if the provided duty-free access under a FTA is applied to the imports from all third countries until the expiration date of the FTA, the internal importers would not deal with the external tariff obstacle and would thus be encouraged to import goods from efficient sources of supply worldwide. Furthermore, the application of RoO in the FTA would not be necessary because no transshipment of goods within the free trade area would happen, and if countries all over the world similarly enjoyed the FTA preferences, there would be no need to ensure whether the imported good is of a partner origin. Only non-preferential RoO would be applied for the other four uses of RoO are: gathering trade statistics, government procurement, carrying out origin marking and labeling requirements, and the application of trade policy instruments. As a result, trade diversion would never find a way to take place within the free trade area.

According to all of the previous arguments, lowering the external MFN tariffs of the RTAs member countries kills three birds with one stone. First, it confronts the transshipment of goods problem within all free trade areas, leading to a reduction in the incentives of their member countries to impose stringent RoO in the FTAs. Consequently, it avoids the trade diversion that takes place within free trade areas because of the imposition of stringent FTAs RoO. Furthermore, it eschews the trade diversion that happens as a result to the formation of RTAs.

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<sup>221</sup> HOLLIDAY, *supra* note 182, at 20.

<sup>222</sup> Panagariya, *supra* note 215, at 508.

*E. The Negative Effects of Article XXIV of the GATT 1947**1. Trade Diversion*

Based on the arguments in the previous subparts, the formation of a RTA could lead to trade diversion in two phases that could happen separately or together. The first phase takes place when the liberalization of tariffs among the RTA member countries makes the intra-regional trade less expensive than extra-regional trade. This liberalization of tariffs and trade outfits the internal suppliers with a rate specialty that the outsider suppliers do not have because of the imposed external MFN tariffs of the RTA partners. The second phase occurs when the RTA imposes stringent RoO that divert the importation of intermediate goods from efficient outsider suppliers to inefficient internal ones for the regional finished goods producers to satisfy the RTA stringent RoO and, thus, trade regionally under preferences.

What is common between the first and the second phase is that both of them take place subsequent to the formation of a RTA. However, trade diversion in both phases happens because of two different non-discriminatory<sup>223</sup> causes. On one hand, the liberalization of tariffs among the RTA member countries is what causes the diversion in the first phase and is discriminatory because the liberalization is provided to only the RTA members and not to third countries. On the other hand, what causes the diversion in the second phase is the stringent RoO. Such rules are of a discriminative nature because they are designed to favor internal suppliers of intermediate goods at the expense of more efficient external ones.

If the formation of a RTA and the consequent liberalization of trade among only the RTA members is allowed under article XXIV (4) of the GATT 1947 as a discriminatory legalized "exception"<sup>224</sup> to the GATT MFN principle,<sup>225</sup> the GATT does not make an exception for or allow the RTA contracting parties to discriminate "between" different "sources of" supply by

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<sup>223</sup> "Non-discrimination takes two forms: non-discriminating among trading partners; and non-discriminating between domestic and foreign producers or suppliers. The former is called the most favoured nation (MFN) treatment principle, while the latter is called the national treatment principle." Hussain H. Zaidi, *Non-discrimination in International Trade*, BUS. & FIN. REV., Apr. 23, 2007, available at <http://www.jang.com.pk/thenews/apr2007-weekly/busrev-23-04-2007/p10.htm>.

<sup>224</sup> It is to be noted that there is more than one exception to the MFN principle. The Enabling Clause of 1979 is another exception besides the illustrated one from which developing countries are allowed to be accorded autonomously from the developed ones' preferences through the formation of a GSP.

<sup>225</sup> Asian Development Bank, *supra* note 51, at 5-6.

imposing stringent, trade-diverting RoO.<sup>226</sup> Hereby, the imposition of the trade-diverting RoO in all preferential trade regimes is of a bias nature and is hence against the GATT MFN principle.

## 2. Other Negative Outcomes

Although the signers of the GATT knew that the formation of regional trade areas under article XXIV of the GATT goes against the GATT MFN principle, they kept in mind that the mentioned formation would bring “welfare” to the RTAs member countries by creating trade within the regional trade areas and by avoiding its diversion therein.<sup>227</sup> Unfortunately, the negative outcomes of forming RTAs vary and are not solely reflected in trade diversion.

Many countries favor the formation of RTAs so as not to comply with the MFN principle, to protect their interests and to discriminate. In addition, the imposition of stringent RoO in a RTA could lead to investment diversion when it induces an outsider-finished goods producer to establish input-producing facilities in a contracting party to the RTA in order to comply with the rules, even though the party is not, economically, the optimum spot.<sup>228</sup>

Bhagwati confirmed that FTAs are of a discriminative nature and, as a result, lead to trade diversion. Furthermore, he stated that industries favor the formation of FTAs to gain by the provided preferences a rate specialty that their outsider rivals would not earn. Moreover, he illustrated that the variation in RoO and “regulations” across FTAs increases the production costs, is deemed to be a dilemma for “customs administration” and leads to what is named as the “spaghetti-bowl” incident.<sup>229</sup>

The formation of a RTA is also detrimental because it diverts the employment from a high wages RTA member state to a “lower wages” member of the same RTA (for example, from the U.S. to Mexico regarding the NAFTA). In addition, it weakens the environmental protection efforts when the establishment of production factories takes place in a RTA member state (usually a developing country) that does not have strong “regulations” against pollution. For instance, the UAW declared that the FTAA,

“[W]ould provide broader protections for the rights of corporations, further undermine the ability of governments in the region to regulate their economies in the interests of their

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<sup>226</sup> *Id.* at 9. In such paper it is clarified “[T]hat trade liberalization under the WTO should not involve any trade diversion, as MFN treatment implies nondiscrimination between sources of imports.” See Cooper, *supra* note 169, at 11.

<sup>227</sup> Cooper, *supra* note 169, at 11.

<sup>228</sup> Ghoneim, *supra* note 49, at 599.

<sup>229</sup> Cooper, *supra* note 169, at 12-13.

citizens and intensify the downward pressure on workers' incomes through competition for jobs and investments. All of this would take place in the absence of any counter-balancing protections for workers, consumers or the environment."<sup>230</sup>

#### *F. As a Proclamation to the WTO Member States*

Since trade diversion, or the shifting the importation of goods from an outsider supplier to a less efficient internal one, is accomplished to discriminate against the goods of the former in favor of those of the latter, it acts as a tool that enables discriminatory treatment that is not normally allowed by the GATT or even considered to be another exception<sup>231</sup> to its MFN principle.<sup>232</sup> Consequently, imposing stringent RoO that are designed to divert trade is discriminatory and is thus contrary to the latter principle.

Imposing stringent RoO in RTAs along with high external MFN tariffs is a trade-isolating barricade that raises hell against outsider goods suppliers and undermines the global efficiency. Hereby, applying any of following solutions is suggested to prevent trade diversion from taking place within all regional trade areas:

- 1) Forming a global free trade area.
- 2) Changing FTAs to CUs, harmonizing the applicable national trade rules among the member countries of each CU, lowering the imposed common external MFN tariffs and implementing tolerant RoO in each CU (this could totally avoid both trade deflection and diversion).
- 3) If the importers of a RTA member state used and/or needs to import cheap goods from an efficient outside supplier, the country of the latter, by making a GATT rule, should be allowed to join the RTA.
- 4) Reducing the external tariffs to the levels of the preferential tariffs.

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<sup>230</sup> *Id.* at 14-15.

<sup>231</sup> The word "another" is written because there is a formerly-indicated exception: the liberalization of trade among only the constituent parties to RTAs pursuant to the principles of Article XXIV of the GATT (1947).

<sup>232</sup> Asian Development Bank, *supra* note 51, at 8. In such paper and page, trade diversion is described as "a new form of discrimination" since the first form of discrimination is subjecting the goods of the contracting parties to any FTA to a duty-free access when they are traded between the parties under the FTA preferences, which is legal and allowed under article XXIV of the GATT (1947). While only the preferences granted under FTAs were regarded as a discriminatory exception that is allowed under the GATT in current cited page, the author regards all preferences granted under all RTAs as discriminatory exceptions allowed under article XXIV of the GATT (1947).



- 5) The imposition of flexible RoO in RTAs and lowering the imposed external MFN tariffs of the RTAs member states.

Implementing any of the previously mentioned solutions could eliminate trade diversion, but since the adoption of the latter solution is the easiest, it concerns us more. Adopting it would encourage the RTAs member countries to source goods from the most efficient suppliers located anywhere in the world, would thus make them able to comply easily with the RTAs RoO and would hence put them in a position to take advantage of the RTAs preferences. Consequently, the RTAs members would witness welfare and the global efficiency would be elaborated.

#### IV. THE HARMONIZATION OF NON-PREFERENTIAL AND PREFERENTIAL ROO

RoO vary from country to country and from one RTA to another. Their variation along with their complexity is considered to be a nightmare for producers and traders all over the world. To determine the origin of a good, one or more than one method could be applied. Moreover, the existence of cumulation rules makes things worse, although they are considered by many to facilitate trade. Even if they facilitate trade, one question arises: how many rules the public and traders have to know in order to practice trade and know their rights and obligations? For this reason, the harmonization of RoO worldwide must be done properly in order to facilitate international trade and to spread welfare all over the world.

Efforts to harmonize RoO were made in 1953 by the ICC. The latter handed in a verdict to the GATT members suggesting that they agree upon a regular “definition for determining the nationality of manufactured goods.”<sup>233</sup> Because some countries declared that the determination of origin should be based on the “national economic policies” of each country while other countries needed a global origin designation criterion along with regular origin-specifying rules, the suggestions of the ICC were not embraced by the GATT.<sup>234</sup>

On September 25, 1974, the Kyoto Convention came into force. Annex D (which is Annex K currently) of the Convention was deemed to be another trail to harmonize RoO.<sup>235</sup> The Kyoto Convention aimed at harmonizing both preferential and non-preferential RoO at which it was

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<sup>233</sup> LaNasa, *supra* note 1.

<sup>234</sup> *Id.*

<sup>235</sup> See Annex D.1 (Rules of origin), Annex D.2 (Documentary evidence of Origin) and Annex D.3 (Control of documentary evidence of origin) of the unrevised version of Kyoto Convention. In the Current revised version of Kyoto Convention, Annex D became K, Annex D.1 became Chapter 1, Annex D.2 became Chapter 2 and Annex D.3 became Chapter 3.

provided with a set of standards to be followed when determining the origin of the imported goods, whether they are wholly obtained in one country or more than one country is engaged their production. According to the Kyoto Convention, when it comes to the latter case, the country of origin is defined as the country where the last substantial transformation was performed. Moreover, the Kyoto Convention lays out a set of principles that specify what operation constitutes a substantial transformation.<sup>236</sup> Unfortunately, many GATT contracting parties did not certify Annex D of the Kyoto Convention. As a result, RoO have been applied pursuant to the national interests of the many countries and the Annex has been regarded as a model to be followed by any of them.<sup>237</sup> In the course of Uruguay Round, the WTO ARoO was discussed. And here comes the role of the ARoO in harmonizing non-preferential RoO.<sup>238</sup>

### A. The Harmonization of Non-preferential RoO

#### 1. The WTO ARoO<sup>239</sup>

“For the purposes . . . of this Agreement, rules of origin shall be defined as those laws, regulations and administrative determinations of general application applied by any Member to determine the country of origin of goods provided such rules of origin are not related to contractual or autonomous trade regimes leading to the granting of tariff preferences.”<sup>240</sup>

The Agreement strives to harmonize non-preferential RoO in a way that can prevent such rules from becoming obstacles to trade. It was formed in order for the WTO member states to comply with a regular pack of harmonized rules when specifying the origin of a product on a MFN grounds.

Pursuant to the previously mentioned article, non-preferential RoO, when harmonized, would not apply in preferential trade regimes.

The harmonization process of non-preferential RoO has been undertaken by the WTO CRO in Geneva in association with the TCRO under the aegis of the WCO in Brussels.<sup>241</sup> The process was supposed to be completed after three years from the commencement of the HWP, which

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<sup>236</sup> See RULES OF ORIGIN IN EXPORT CREDIT INSURANCE, INT’L TRADE FORUM 3 (2001).

<sup>237</sup> Inama, *supra* note 145, at 2.

<sup>238</sup> See RULES OF ORIGIN IN EXPORT CREDIT INSURANCE, *supra* note 236, at 3.

<sup>239</sup> Full text of the Agreement is available at the World Trade Organization Website. World Trade Organization, [http://www.wto.org/english/docs\\_e/legal\\_e/22-roo.pdf](http://www.wto.org/english/docs_e/legal_e/22-roo.pdf) (last visited Mar. 25, 2009).

<sup>240</sup> ARoO, *supra* note 2, Art. 1(1).

<sup>241</sup> World Trade Organization, [http://www.wto.org/english/thewto\\_e/minist\\_e/min96\\_e/rules.htm](http://www.wto.org/english/thewto_e/minist_e/min96_e/rules.htm) (last visited Mar. 25, 2009).

started on 20 July 1995 (i.e. by 20 July 1998).<sup>242</sup> However, it has not been completed yet due to the existence of a number of outstanding issues.<sup>243</sup> Most of the issues are based upon PSRoO.

Because a stage of transition is needed to harmonize the non-preferential rules of origin, the ARoO is outfitted with a set of principles that must be followed by the WTO member states before and after the completion of the harmonization process.

Prior to the completion of the harmonization process (during the transition period), the WTO member states shall comply with *status quo* and are not allowed to make alterations to their RoO that suit their interests and protect their national susceptible goods. Besides, their RoO must be imposed transparently, without discrimination, without hindering international trade, orderly and non-retroactively, if they are *de novo*.<sup>244</sup> Unfortunately, complying with the mentioned principles is not the intention of many WTO member states, pursuant to what is clarified in the previous two parts of this paper.

Subsequent to the completion of the harmonization process of non-preferential RoO, all WTO member states will have to comply with a regular single pack of harmonized RoO when specifying the origin of a product on a MFN grounds. Furthermore, the origin of the product will be determined according to the last substantial transformation norm<sup>245</sup>, where the CTC test is to be applied, if more than one country is involved in the production of the good (i.e. if the product is not wholly-obtained).. Besides, the required change should be done at the CTH level or the CTSH one, if the latter is necessary (i.e. “the minimum change within the nomenclature”). Moreover, in case the CTC does not confer origin for the product, the VA and/or the Specific Processing test are to be implemented.<sup>246</sup>

Once the harmonization process is completed, the harmonized non-preferential RoO should be integrated in the agreement as an annex, and consequently, the WTO member states would have to bring them into effect on a MFN grounds from the enforcement date specified by the WTO Ministerial Conference.<sup>247</sup>

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<sup>242</sup> *Id.* Art. 9(2)(a). See also World Trade Organization, [http://www.wto.org/english/news\\_e/pres98\\_e/pr106\\_e.htm](http://www.wto.org/english/news_e/pres98_e/pr106_e.htm) (last visited Mar. 25, 2009).

<sup>243</sup> See also World Trade Organization, [http://www.wto.org/english/tratop\\_e/roi\\_e/roi\\_info\\_e.htm](http://www.wto.org/english/tratop_e/roi_e/roi_info_e.htm) (last visited Mar. 25, 2009).

<sup>244</sup> Agreement on Rules of Origin, *supra* note 2.

<sup>245</sup> *Id.* Art. 3(b).

<sup>246</sup> *Id.* Art. 9(2).

<sup>247</sup> *Id.* Art. 9(4).

## 2. The Outstanding Issues Obstructing the Completion of the Harmonization Process of Non-preferential RoO

In June 1999, 486 suspended issues were submitted to the CRO.<sup>248</sup> The CRO unraveled twenty-two issues by September 2000. In November 2001, eight more issues were unraveled. By March 2001, the number of unraveled issues became fifty-four. In May 2001, forty-two issues were resolved. In July 2001, sixty-seven issues were worked out. In October 2001, 115 issues were unraveled. By December 2001, fifty-three further issues were resolved which makes the total number of unraveled issues until then 331, and the total number of suspended issues was 155.<sup>249</sup>

Product groups	Number of issues referred to the CRO	Number of resolved issues	Number of outstanding issues	% of resolved issues
1-24 (Agricultural products)	125	63	62	50
25-27 (Mineral products)	10	8	2	80
28-40 (Chemicals)	38	27	9	71
41-43 (Leather)	8	6	2	75
44-49 (Wood and paper)	11	11	0	100
50-63 (Textiles)	83	50	33	60
64-67 (Footwear)	14	9	5	64
68-70 (Ceramics)	12	9	3	75
71 (Precious stones and metals)	5	5	0	100
72-73 (Steel)	12	9	3	75
74-81 (Non-ferrous)	24	19	5	79
82-83 (Articles of metal)	17	17	0	100
84-90 (Machinery)	86	69	17	80
91 (Clocks and watches)	6	5	1	83
92-97 (Miscellaneous articles)	35	31	4	89
<b>TOTAL</b>	<b>486</b>	<b>331</b>	<b>155</b>	<b>68</b>

Source: WTO (2001).

Additional progress was achieved by June 2002, at which time the total number of resolved issues became 348 out of the 486. Hence, the number of suspended issues to that time became 138.<sup>250</sup> By June 31, 2002, the CRO referred ninety-four issues to the General Council. The time limit for resolving the issues was extended to July 2004. In addition, the General Council declared that the CRO would accomplish its harmonization task by December 31, 2004 once the issues were resolved.<sup>251</sup> The referred issues were one wholly obtained, one "implication," and ninety-two product-specific. The wholly obtained issue concerned the question of what origin to confer on the fish picked up in the Exclusive Economic Zone and more specifically, whether it should be based on the flag of the member attached to the fishing smack or

<sup>248</sup> World Trade Organization, G/RO/41 (Sept. 3, 1999).

<sup>249</sup> World Trade Organization, G/RO/49 (Dec. 17, 2001).

<sup>250</sup> Committee Report, *Report By the Chairman of Committee on Rules Of Origin to the General Office*, G/RO/52 (Jul. 15, 2002).

<sup>251</sup> *Id.*; see also Vermulst, *supra* note 6, at 8.

on the littoral member. The second issue concerned the impact the harmonized RoO would have on other WTO agreements.

The General Council decided to concentrate on twelve of the ninety four issues as follows: “Implications of the implementation of the Harmonized Rules of Origin on other WTO Agreements; Dyeing and printing of textile products; Coating of steel products; Assembly of machinery; Assembly of vehicles; Refining of sugars; Roasting of coffee; Slaughtering of live animals; Refining of oils; Fish taken from the sea of the exclusive economic zone; Footwear; and Dairy products”<sup>252</sup> Currently, about thirty products are implicated in outstanding issues on PSRoO.<sup>253</sup> The refusal of the WTO contracting parties to settle these issues is reflected in their importance, since such issues act upon the interests of the parties. This is why cooperation is needed between the WTO member states to resolve the mentioned outstanding issues.

### *3. Problems Concerning the Application of RoO Worldwide and Suggestions to Overcome the Odds*

#### *a. The CTC Method*

The implementation of the CTC method is flexible and uncomplicated. However, its application is relevant to the HS, seeing that a profound acquaintance concerning the latter would be required once the non-preferential RoO are harmonized. Moreover, the HS was not formed, on the whole, for origin specification objectives. That is why the itemization of two kinds of certain production processes are needed: processes that do not grant the originating status, even though they engender a CTC, and processes that grant the originating status, in spite of the fact that they do not result in a CTC.<sup>254</sup> After harmonizing the non-preferential RoO, particularly in a case where the CTC does not confer origin for the product, the VA and/or the Specific Processing tests are to be applied. The issues concerning both of the latter tests are discussed below.

#### *b. The VC requirement:*

There are three types of the VC requirements:

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<sup>252</sup> Vermulst, *supra* note 6, at 9. See also WALTER STOCKER, THE WCO SEMINAR ON THE HARMONIZATION OF NON-PREFERENTIAL RULES OF ORIGIN (2008), available at [http://www.dga.gov.do/dgagov.net/uploads/file/seminario\\_regional\\_oma/01rules-of-origin-english.pdf](http://www.dga.gov.do/dgagov.net/uploads/file/seminario_regional_oma/01rules-of-origin-english.pdf) (discussing details concerning similar issues and their resolution).

<sup>253</sup> Estevadeordal, *supra* note 47, at 13.

<sup>254</sup> Vermulst, *supra* note 6, at 5.

- The import VC requirement: if the percentage of the imported inputs used in producing the product is not higher than the permitted utmost one specified by the rule, origin is to be conferred to the product.
- The local VC requirement: origin is to be conferred to the product if the percentage of the domestic value that has been appended in the country claiming origin is not lower than the required least one specified by the rule.
- The value of originating parts requirement: origin is to be conferred to the product if the percentage of the originating parts used in its production out of the aggregate is not lower than the least one specified by the rule.<sup>255</sup>

Although the VC test is transparent and uncomplicated when identified, there are defects in its application.

*i. The Denominator and the Numerator: An  
Emphasis on the EC's Practice*

To calculate the percentage of the local content, the numerator should be divided by the denominator and then multiplied by 100. To calculate the percentage of the import content, the value of the non-originating materials—at the specified delivery term—should be divided by the denominator and then multiplied by 100. The numerator is the sum of the factors that are counted as parts of the local content. The denominator is the delivery term the finished good is to be valued at.

Pursuant to the Recommended Practice 5 of Chapter 1 of Annex K of Kyoto Convention, the finished goods should be valued at the ex-works or the FOB price<sup>256</sup> (the denominator). Moreover, the imported inputs should be valued on a CIF basis.<sup>257</sup> The EC uses the ex-works price<sup>258</sup> as the

<sup>255</sup> *Id.* at 6.

<sup>256</sup> The FOB price in the Recommended Practice 5 of Chapter 1 of Annex K of Kyoto Convention is referred to as “the price at exportation.”

<sup>257</sup> The CIF price in the Recommended Practice 5 of Chapter 1 of Annex K of Kyoto Convention is referred to as “the dutiable value at importation.”

<sup>258</sup> Fourth ACP-EEC Convention, Dec. 1, 1989, 29 I.L.M. 783 (1990), available at [http://aei.pitt.edu/4220/01/001701\\_1.pdf](http://aei.pitt.edu/4220/01/001701_1.pdf). According to Article 3(2) (c) of Protocol 1 of Lomé IV, the ex-works price “shall mean the price paid for the product obtained to the manufacturer in whose undertaking the last working or processing is carried out, provided the price includes the value of all the materials used in manufacture, minus any internal taxes which are, or may be repaid when the product obtained is exported”); see also Commission Regulation (EEC) No. 2454/93, art. 40 (1993) (laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code 1993 O.J. (L 253), 11.10, available at [http://www.furs.si/law/EU/zvr/zakonodaja\\_CIRCA/EU\\_circa/carina/31993R2454.p](http://www.furs.si/law/EU/zvr/zakonodaja_CIRCA/EU_circa/carina/31993R2454.p)

denominator. The ex-works price is the cost of the good from the manufacturing firm. This price includes all costs incurred in producing the good up to placing it in the manufacturing firm - i.e. it includes the costs of all inputs<sup>259</sup> (the cost of the originating inputs + the value of the non-originating inputs at the specified delivery term),<sup>260</sup> direct labor costs,<sup>261</sup> factory costs, SG&A expenses,<sup>262</sup> packing expenditures and profit (if available).<sup>263</sup>

All of the mentioned elements, with the exception of the value of the non-originating inputs, are factors counted as part of the local content. Their sum gives the numerator if the ex-works price is used as the denominator. That is why determining what factor is to be counted as part of the local content, and consequently calculating the numerator depends on the

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df ("ex-works price" means the ex-works price of the product obtained minus any internal taxes which are, or may be, repaid when such product is exported").

<sup>259</sup> Both kinds of inputs (the originating and the non-originating) are known as direct materials.

<sup>260</sup> For example, if the imported inputs are valued at the FOB price, all costs incurred in producing the inputs up to delivering them on board the shipping vessel, at the agreed specified export port (pursuant to the terms of the sale contract), will be regarded as non-originating and all charges incurred for transportation and insurance will be regarded as originating. Hence, only such originating charges will be included in the denominator and will be thus regarded as part of the local content.

<sup>261</sup> The manufacturing costs (or product costs) consist of direct and indirect manufacturing costs. While the direct manufacturing costs comprise the direct materials and direct labor costs, the indirect costs comprise the factory costs (or manufacturing overheads). The factory costs include the indirect labor, indirect materials and factory-related costs.

<sup>262</sup> See Ben McClure, Introduction to Fundamental Analysis, <http://www.investopedia.com/university/fundamentalanalysis/> (The SG&A expenses, *ipso facto*, include the wages for administrators, royalties (only if they are rational under the EC's standards), insurance, traveling expenditures for the administrators and those who are assigned to sell the goods, expenses for heat and lighting, costs of leasing facilities, and payroll outlays. However, when it comes to using the ex-works price as the denominator, any SG&A expenses incurred subsequent to the departure of the product from the manufacturing firm must be taken away. Thus, direct selling expenses will be disregarded).

<sup>263</sup> Edwin Vermulst, *Rules of Origin as Commercial Policy Instruments? Revisited*, in *RULES OF ORIGIN IN INTERNATIONAL TRADE: A COMPARATIVE STUDY* 442, 433-85 (E. Vermulst, P. Waer & J. Bourgeois eds., 1992), available at [http://www.vwv-law.be/publications/ORIGIN\\_CHAPTER9.pdf](http://www.vwv-law.be/publications/ORIGIN_CHAPTER9.pdf). See also, in such book, a comparative analysis on the usage of different denominators and the numerator calculations by different jurisdictions: the U.S., the EC, Japan, Australia and Canada. It is to be noted that under the EC's standards, if the profit is not rational, it will not be included in the denominator or the ex-works price.

denominator used.<sup>264</sup> It is clear, then, from the previous explanation that the denominator is the addition of numerator to the value of the non-originating materials.

The EC uses the CIF price to value the imported inputs<sup>265</sup>, at which any payable charges “incurred from” transiting the inputs from the manufacturing firm till reaching the boundary of the importing country are to be regarded as non-originating and at which the payable charges incurred after crossing the boundary of the importing country are to be regarded as originating.<sup>266</sup>

Since the EC uses the ex-works price as the denominator and values the imported inputs at the CIF price, it complies with the Recommended Practice 5 of Chapter 1 of Annex K of Kyoto Convention.

Although valuing the finished goods at the FOB price complies with the Recommended Practice 5 of Chapter 1 of Annex K of Kyoto Convention and results in the containment of the numerator to more local content factors,<sup>267</sup> the ex-works price has been agreed to be more adequate than the FOB price when used as the denominator.<sup>268</sup> In addition, using the latter as the denominator is deemed to be unfair to the factories that are situated far away from the seaport because the more distance that exists between the factory and the seaport, the more transportation costs from the factory to the seaport will have to be paid. Thus, using the FOB as the denominator will provide the factories situated near the seaport with a specialty (less transportation costs) that the factories situated far away from the seaport will not have. Hereby, using the ex-works price instead of the FOB price as the denominator is deemed to be more fair than vice versa, albeit the fact that using any of them

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<sup>264</sup> However, that is not always the case because although the U.S. in its preferential trade regimes uses the FOB price as the denominator which comprises the SG&A expenses and profit, it does not count the latter elements as local content factors (only royalties are included in the numerator because sometimes they are comprised in the factory costs and not the SG&A expenses). *See id.* at 441.

<sup>265</sup> Commission Regulation (EEC) No 2454/93 (Jul. 2, 1993). Pursuant to Article 40, “origin is conferred if the value of the non-originating materials used does not exceed a given percentage of the ex-works price of the products obtained, such percentage shall be calculated as follows: ‘value’ means the customs value at the time of import of the non-originating materials used or, if this is not known and cannot be ascertained, the first ascertainable price paid for such materials in the country of processing,” *available at* <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CONSLEG:1993R2454:20010701:EN:PDF>.

<sup>266</sup> *See Vermulst, supra* note 263, at 438.

<sup>267</sup> When compared with using the ex-works price as the denominator.

<sup>268</sup> *See, e.g.,* Secretariat Note, *Customs Cooperation Council-Rules of Origin of Goods*, 29.215E T7-3231, at 20 (Nov. 2, 1982); *see also* Vermulst, *supra* note 263, at 442.



as the denominator complies with the logical recommendations of Kyoto Convention.

Since the denominator and the numerator used to calculate the VC percentage may differ from one country to another,<sup>269</sup> using the EC's standards of calculating the VC percentage as model to be followed by all WTO member states seems to be the most reasonable solution because, as previously mentioned, the EC complies with the rational recommendations of Kyoto Convention when it comes to calculating the VC percentage, i.e. to use the ex-works price as the denominator, to value the imported inputs at the CIF price<sup>270</sup> and to use the same EC's local content factors for calculating the numerator.<sup>271</sup>

## ii. *Chastising Efficient Production Processes:*

The VC requirement chastises "low cost or efficient production operations"<sup>272</sup> in countries with cheap labor and inputs because such cheapness makes it difficult for the producers to include costly local content factors in the numerator to comply easily with the VC requirement, contrary to the producers in countries with expensive labor and inputs. Consequently, lesser-developed countries, by reason of the VC requirement, are discriminated against and do not benefit from the advantage of low-cost production operations that they only have over developed countries.<sup>273</sup> Despite that, after the harmonization of non-preferential RoO, the efficient producers in the lesser-developed countries would not deal with the aforementioned problem in most cases because the VC

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<sup>269</sup> For instance, the denominator used in the U.S. preferential trade schemes is the transaction value. The transaction value is "the value of the good adjusted to a F.O.B. basis." *See, e.g.,* Agreement on the application by Mexico of a North American Free Trade Agreement Safeguard Measure on Certain Poultry, July 24, 2003, 2003 WL 22324890.

<sup>270</sup> While the EC, Japan, Australia and Canada use the CIF price to value the imported inputs, the U.S. uses the FOB one. *See* Vermulst, *supra* note 263, at 438.

<sup>271</sup> *Id.* at 438, 478. It could have been sufficient to urge for using the EC's denominator and the valuation criterion of imported inputs (the CIF price) since this would consequently specify what factor is to be counted as part of the local content. However, that is not always the case because although the U.S., for example, in its preferential trade regimes uses the FOB price as the denominator which comprises the SG&A expenses and profit, it does not count the latter elements as local content factors (only royalties are counted because sometimes they are comprised in the factory costs and not the SG&A expenses). This is why all WTO member states should use the same EC's local content factors to calculate the numerator since this, as illustrated, is the most reasonable solution. *See id.* at 441-42, 444-45, 478.

<sup>272</sup> *Id.* at 447.

<sup>273</sup> *See* Brenton, *supra* note 128, at 22.

requirement is going to be used as a supplementary, and not primary, origin designation criterion.

iii. *The Instability of the Inputs Prices  
Worldwide and the Changeableness of  
Exchange Rates*

Due to the instability of the inputs prices and “exchange rates,” calculating the percentage of the VC is inconstant.<sup>274</sup> However, if the percentage of the VC test to be complied with is going to be tolerant after the harmonization of non-preferential RoO,<sup>275</sup> the producers globally would have the ability to import inputs of varying qualities and at different prices from anywhere, and would regard consequently the vicissitude of the inputs prices worldwide as a blessing.. Moreover, the producers in countries with insufficient or limited domestic sources of supply would not have to worry about increasing the percentage of the local content.

An example of a tolerant VC requirement is indicated in the Canada–Chile FTA in which a RVC of thirty five percent is required to be complied with under the transaction value method.<sup>276</sup>

Pursuant to Brenton, “[a]n operation which confers origin today may not do so tomorrow if exchange rates change.”<sup>277</sup> Actually, the problem of unstable exchange rates might not be solved, unless a global economic and monetary union is going to be formed. However, Brenton used the word “may” which clarifies that the vice versa of what he said may happen, i.e. an operation which does not confer origin today may confer it tomorrow, if exchange rates change *positively*.

iv. *The Import VC requirement vs. the Local  
VC One*

The WCO should take a decision on whether the applicable VC requirement is going to be the import VC requirement or the local VC one.<sup>278</sup>

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<sup>274</sup> See LaNasa, *supra* note 1. See also Teruo Ujie, *Trade Facilitation, Manila, Asian Development Bank 11* (Asian Dev. Bank, Econ. & Research Dep’t, Working Paper Series No. 78, 2006).

<sup>275</sup> That would be the case when it comes only to using the VC requirement as a supplementary origin determination method.

<sup>276</sup> See Canada-Chile Free Trade Agreement, Can.-Chile, July 4, 1997, *available at* <http://www.international.gc.ca/trade-agreements-accords-commerciaux/agr-acc/chile-chili/anxd1/sect2-chap84-2.aspx?lang=en>.

<sup>277</sup> See Brenton, *supra* note 128, at 22.

<sup>278</sup> See Vermulst, *supra* note 263, at 478.

Generally, the import VC requirement is applied by many jurisdictions.<sup>279</sup> For example, it is applied in the EU preferential trade regimes. Moreover, applying it is uncomplicated.<sup>280</sup> Its application would lessen the administrative obstacles<sup>281</sup> and would not need circumstantial instantaneous inspections on the “data provided.”<sup>282</sup>

v. *The Consistent Harmonization of the Non-preferential RoO that Depend on the VC Requirement*

Based on the arguments in the previous subparts, the WCO has to bear in mind that the EC's denominator (ex-works price), local content factors and valuation method of imported inputs (CIF price) used in calculating the VC percentages can lay an optimal groundwork for the harmonization of non-preferential RoO that depend on the VC requirement. In addition, the import VC requirement of a tolerant percentage to be complied with should be the supplemental origin designation method.

c. *The Specific Manufacturing Operation Method*

Like the VC test, the specific manufacturing operation method is transparent and not obscure when identified. It is also concrete; however, it has its share of defects. The specific manufacturing process method engenders always product-specific RoO<sup>283</sup> and is misused pursuant to national “interests.”<sup>284</sup> Though, by solving the product-specific outstanding issues and by completion of the harmonization process of non-preferential RoO, the specific manufacturing operation method would not engender anymore product-specific origin rules and would not be misused pursuant to national interests.

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<sup>279</sup> See Rajan Ratna, *Rules of Origin: Diverse Treatment and Future Development in the Asia and Pacific Region*, in ECON. & SOCIAL COMM'N FOR ASIA & THE PACIFIC 76, 67-91 (2008). See also Brenton, *supra* note 128, at 21.

<sup>280</sup> Applying it is uncomplicated because the import VC percentage can be simply calculated by adding only the costs of the imported inputs valued at the specified delivery term together, dividing such costs by the denominator and multiplying the remainder by 100, contrary to calculating the percentage of the local VC where the costs of a variety of local content factors must be added together before being divided by the denominator and then multiplied then by 100.

<sup>281</sup> Administrative obstacles take place particularly when it comes to using the value of originating parts requirement. In spite of this, such obstacles will be lessened if the import VC requirement is going to be supplementary origin determination criterion after the harmonization of non-preferential RoO.

<sup>282</sup> See Vermulst, *supra* note 263, at 448-49, 479.

<sup>283</sup> See Brenton, *supra* note 128, at 17.

<sup>284</sup> See Vermulst, *supra* note 263, at 450.

Another problem with the specific manufacturing operation test determining when the rule of origin requires the measurement of complicated production operations. The rule then becomes stringent and compliance with it becomes difficult.<sup>285</sup> That is why the WCO should keep in mind that the rule should require the simplest possible operations to be taken for producing the good when it comes to using the specific manufacturing operation test as a supplementary origin designation method.

An example for a tolerant specific manufacturing operation rule is that indicated in DR-CAFTA, where the reasonable single transformation process is required to be complied with for certain apparel products which are: "brassieres (HTS subheading 6212.10), certain woven boxer shorts and pajamas (found in HTS headings 6207 through 6208), and certain woven women's/girls' dresses (found in HTS subheadings 6204.42 through 6204.44)."<sup>286</sup>

#### 4. *The Road So Far and a Bright Road Ahead*

If all of the suggestions, arguments and analysis mentioned so far in this part are to be taken into consideration by the WCO when harmonizing the non-preferential RoO and cooperation between the WTO member states is used to resolve the outstanding issues, the non-preferential RoO will be harmonized and integrated in the agreement as an annex, and the contracting parties will consequently have to carry them out from the enforcement date specified by the ministerial conference. Thereupon, the origin of the product will be determined according to a clear substantial transformation norm where the CTC (either CTH or CTSH) method will be applied when more than one country is involved in the production of the good and reinforced, if needed, by the VC and/or the specific manufacturing operation tests.

Pursuant to the WTO negotiating text of 2008, the morphology of the non-preferential RoO once harmonized will consist of definitions, general rules,<sup>287</sup> an Appendix on wholly obtained goods, and Appendix on PSRoO.<sup>288</sup>

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<sup>285</sup> See Brenton, *supra* note 128, at 17 (explaining the advantages, disadvantages, and key issues of the three methods of determining origin).

<sup>286</sup> See U.S. Int'l Trade Comm'n, *Probable Economic Effect of Modifications to DR-CAFTA Rules of Origin and Tariffs for Certain Apparel Goods*, Investigation No. DR-CAFTA-103-16, USITC Publication 3946, Report No. USITC/PUB-3946, (Sept. 2007), at 2-6.; see also Eric O. Autor, Presentation at Guatemala Apparel and Textile Exporters Commission (VESTEX) Apparel Sourcing Show 2, Apr. 19, 2007, [www.nrf.com/modules.php?name=Documents&op=viewlive&sp\\_id=313](http://www.nrf.com/modules.php?name=Documents&op=viewlive&sp_id=313).

<sup>287</sup> There are six rules; they are: 1) Harmonized System, 2) Determination of Origin, 3) Neutral Elements, 4) Packing and Packaging Materials and Containers, 5) Accessories and Spare Parts and Tools, and 6) Minimal Operations and Processes.

Currently, the reference of the negotiating text of the WTO is G/RO/W/111/Rev.3. Although there has been unofficial progress, the harmonization of non-preferential RoO is not over.<sup>289</sup>

Having a single regular set of non-preferential RoO would ensure the WTO member states' compliance with *status quo* without giving them the chance to make alterations to any origin rule that suits their interests and protects their national susceptible goods, and would consequently cease the occurrence of any dispute that could be aroused, like the U.S – India one. In addition, customs administrations worldwide would not face any more dilemmas caused by a variety of origin rules imposed differently by each WTO member state. Further, non-preferential RoO would not be considered a nightmare for producers and traders all over the world.

## B. Harmonizing Preferential RoO

During the Uruguay Round, the harmonization of preferential RoO was proposed. In return, the ARoO in Annex II (Common Declaration with Regard to Preferential Rules of Origin) has been covering principles that the WTO member states must comply with when imposing RoO in whether autonomous or contractual trade regimes.<sup>290</sup> Such principles are much closer to those clarified by the agreement under its article 2. The exception of preferential RoO from the harmonization process undertaken by the WCO and specified in the ARoO reflects the will of the WTO member states to use them according to their interests. In 1995, a group of intergovernmental experts met in order to discuss the issues of harmonizing the preferential RoO of the GSP to make it easier for developing countries to take advantage of the GSP accorded preferences.<sup>291</sup> That is why many have supported the harmonization of preferential RoO and many see that it is of crucial importance.

Preferential RoO are divided with great elaboration in RTAs. They could be itemized in 200 pages. For instance, the PSRoO of NAFTA is specified in about 200 pages. Moreover, the application of preferential RoO differs from an agreement to another, making things complicated for a trader when her country appears to be a member in a variety of agreements that impose different RoO. Even enterprises face difficulties when complying with a diversity of costs provoked by different agreements that lead to what is named as the “Spaghetti Bowl” phenomenon. Furthermore, the CTC method

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<sup>288</sup> World Trade Organization, *Negotiating Texts for the Harmonization Work Programme*, G/RO/45/W/111/Rev.1 (Feb. 25, 2008).

<sup>289</sup> E-mail from Pierre de Vaucher to Hatem Mabrouk, Ph.D. Student, School of Law at the University of Dundee (Jan. 9, 2009) (on file with author).

<sup>290</sup> Vermulst, *supra* note 6, at 8.

<sup>291</sup> See Inama, *supra* note 145, at 16 (citing UNCTAD); see also Agreed Conclusions of the Intergovernmental Group of Experts on Rules of Origin, TD/B/COM.2/13 (1995).

applied in many preferential trade regimes sometimes requires the change to be done at the tariff item level, which does not conform with the CTC test included in the harmonization efforts of non-preferential RoO, where the minimum change in the tariff classification or the CTH is to apply in case the CTH is enough to confer origin.

*1. Negotiations are Taking Place and Must Be Taken into Account, if Efforts to Harmonize Preferential RoO are Going to Come into Existence*

The ASEAN has negotiated and is negotiating FTAs with China, Japan, India, Republic of Korea, Australia and New Zealand. Such FTAs include, or will include for the ones that are still in negotiations, the 10 ASEAN member states<sup>292</sup> and the contracting FTA party, which makes the total eleven.<sup>293</sup> That is why the ASEAN FTAs are one of the biggest FTAs in the world.

There were also proposals to form the ASEAN+6 FTA that will include the following ten ASEAN member states + China, Japan, the ROK, India, Australia and New Zealand.<sup>294</sup> Therefore, if the ASEAN is going to form a single FTA with a single set of harmonized preferential RoO with all of the mentioned countries, then this must be taken into account when efforts to harmonize preferential RoO come into existence.

The APTA (which was known as the Bangkok Agreement) is also one of the largest RTAs, consisting of six contracting parties: Bangladesh, India, Lao People's Democratic Republic, the Republic of Korea, and Sri Lanka. Efforts were made to include more contracting parties from Central Asia. The secretariat of the United Nations Economic and Social succeeded in harmonizing the Asia-Pacific Trade Agreement RoO. Such rules are uncomplicated, plain, all-inclusive and reasonable. For instance, a forty five

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<sup>292</sup> Namely, the Government of Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam. Association of Southeast Asian Nations Homepage, <http://www.aseansec.org/64.htm> (last visited July 1, 2009).

<sup>293</sup> For more information, see the agreements and the Framework Agreements on Comprehensive Economic Cooperation between the Association of Southeast Asian Nations and the mentioned countries. Association of Southeast Asian Nations, AFTA & FTAs, <http://www.aseansec.org/4920.htm> (last visited July 2, 2009).

<sup>294</sup> See Ratna, *supra* note 279, at 98. See also *East Asia Summit: In the Shadow of Sharp Divisions*, PEOPLE'S DAILY ONLINE, Dec. 7, 2005, [http://english.people.com.cn/200512/07/eng20051207\\_226350.html](http://english.people.com.cn/200512/07/eng20051207_226350.html). See also National News Bureau of Thailand, ASEAN+6, Mar. 21, 2009, [http://thainews.prd.go.th/newsenglish/14th\\_aseansummit\\_e/index.php?option=com\\_content&task=view&id=86&Itemid=6](http://thainews.prd.go.th/newsenglish/14th_aseansummit_e/index.php?option=com_content&task=view&id=86&Itemid=6).

percent local VC is imposed.<sup>295</sup> Since harmonizing RoO in such a simple way was accomplished in the APTA, there is a big possibility to achieve someday a successful harmonized set of preferential RoO.

The APEC consists of 21 member states.<sup>296</sup> Many agreements are formed between its members. One of the attempts to form a single RTA between the members was conducted by the former U.S. President Bush, to form a so-called APEC-wide FTA.<sup>297</sup> In addition, the heads of the APEC ratified the report on Strengthening Regional Economic Integration in 2007. In the report, the heads declared that by carrying some dissecting steps the formation of the FTAAP can be practicably achieved and that the RoO imposed in the variety of RTAs formed between the APEC members are recommended to be checked up with a plan aiming at making them reasonably imposed.<sup>298</sup>

The 2009 APEC arrangements instruct its members to:

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<sup>295</sup> Ratna, *supra* note 279, at 87.

<sup>296</sup> Namely, Australia, Brunei Darussalam, Canada, Chile, People's Republic of China, Hong Kong - China, Indonesia, Japan, Republic of Korea, Malaysia, Mexico, New Zealand, Papua New Guinea, Peru, the Philippines, Russia, Singapore, Chinese Taipei, Thailand, the United States and Vietnam. APEC: Member Economies, [http://www.apec.org/apec/member\\_economies.html](http://www.apec.org/apec/member_economies.html) (last visited July 15, 2009).

<sup>297</sup> See Connie Levett, *Bush Pushes on APEC Free Trade Agreement*, THE AGE, Nov. 15, 2006, at 8, <http://www.theage.com.au/news/national/bush-pushes-on-apec-free-trade-agreement/2006/11/14/1163266550761.html>.

<sup>298</sup> APEC ECONOMIC LEADERS, THE REPORT ON STRENGTHENING REGIONAL ECONOMIC INTEGRATION: A REPORT ON REGIONAL ECONOMIC INTEGRATION, INCLUDING A POSSIBLE FREE TRADE AREA OF ASIA-PACIFIC AS A LONG-TERM PROSPECT (2007), *available at* [http://www.apec.org/etc/medialib/apec\\_media\\_library/downloads/committees/cti/pubs/2007.Par.0025.File.v1.1.](http://www.apec.org/etc/medialib/apec_media_library/downloads/committees/cti/pubs/2007.Par.0025.File.v1.1.)

- Examine the various types of preferential rules of origin used in the APEC region with the aim of increasing knowledge of their similarities and differences.
- Explore, in close cooperation with the business sector, how rules of origin used in economies' RTAs/FTAs might be rationalized.
- Expand dialogue on examining ways to achieve greater consistency in key provisions of RTAs/FTAs in the region.
- Expand and deepen the convergences/divergences study by adding to the agreements and chapters covered in 2008.
- Examining the feasibility of enlarging, docking or merging existing FTAs.
- Conduct analytical work on the economic impact of a FTAAP and on the specific benefits and challenges for APEC economies associated with such an agreement.

Friends of the Chair (FOTC) groups on REI\* set up at both the CTI\*\* and Senior Officials levels will continue to oversee the work on the REI agenda. The CTI-FOTC will liaise with the relevant sub-fora to help them prioritize their REI-related work.. The CTI-FOTC has agreed to focus its initial work in 3 areas: rules of origin, convergences and divergences of FTAs, and docking, merging and enlargement of FTAs.

Capacity building workshops, policy dialogues, or symposia will continue to be conducted at the CTI/CTI sub-forum level, allowing exchanges between government officials and FTA negotiators on best practice and strengthening FTAs in the region.

*Source:*

[http://www.apec.org/apec/apec\\_groups/other\\_apec\\_groups/FTA\\_RTAs.html](http://www.apec.org/apec/apec_groups/other_apec_groups/FTA_RTAs.html)

\* Stands for Regional Economic Integration.

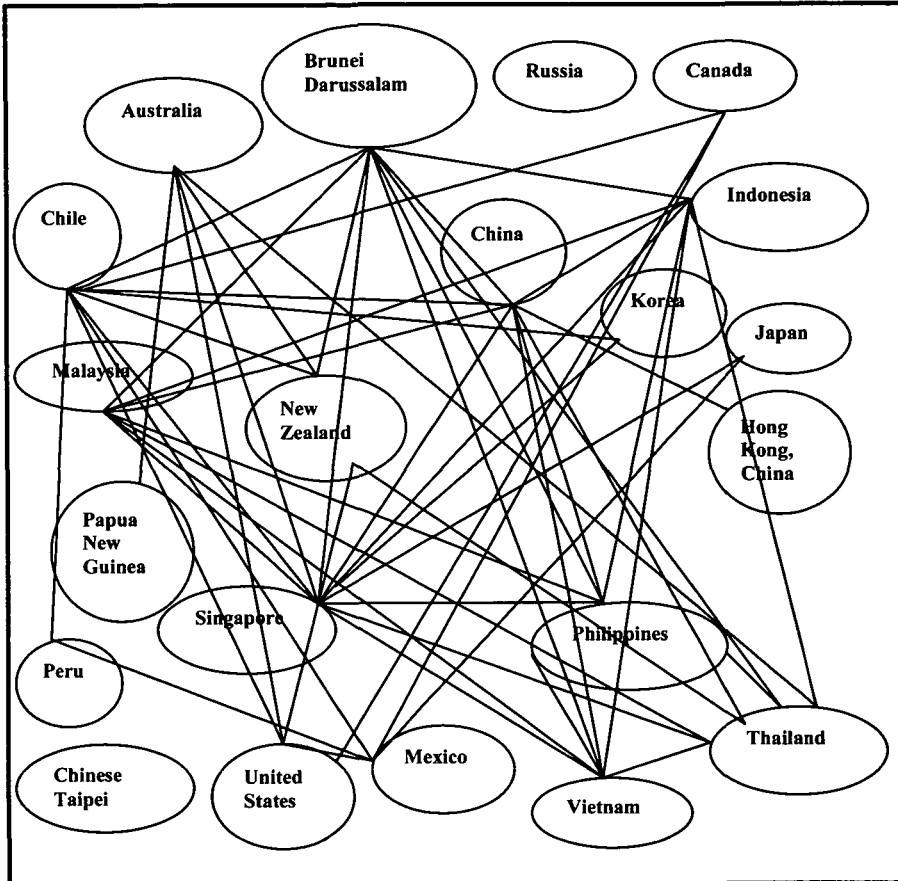
\*\* Stands for Committee on Trade and Investment.

Forming a single RTA between the APEC member states with a reasonably imposed uniform set of harmonized RoO reflects the possibility to harmonize preferential RoO in a wise manner, and will reduce the effect of the Spaghetti Bowl incident.

The following figure shows the bulk of the Spaghetti Bowl Phenomenon within the APEC region. In fact, such phenomenon should be named "the Plague" instead because deeper look at the figure shows RTAs spreading like the Plague virus. One should also realize that Russia and Chinese Taipei are the only cleanest circles in the figure, having not yet been infected since they have not negotiated any RTA with any of the APEC member states. The Plague, or Spaghetti Bowl, is deemed to be a nightmare



for traders. More importantly, it acts like a virus and epidemic that infects international trade with hindrance. The circles in the next figure represent the APEC members, with the lines representing an existing RTA between the circles/members they connect with each other.



Source: Author's analysis based on

[http://www.apec.org/webapps/fta\\_rta\\_information.html#others\\_fta](http://www.apec.org/webapps/fta_rta_information.html#others_fta)

If the FTAAP is going to be formed, which could to a great degree take place pursuant to the clarified information, a single set of harmonized RoO between the APEC members would be imposed, taking into consideration the mentioned efforts to impose them in a reasonable manner. That is why harmonizing the RoO between the APEC countries should be taken into consideration, in case any attempt to harmonize preferential RoO are coming into existence.

- The current EU attempts to harmonize its preferential RoO should also be taken into account.

**“Breakdown of use of ROO criteria in EU preferential trade agreements”**

**Source: EC (2005b)**

Method:	WO	CTH	SP	VA	WO+CTH	WO+VA
Number of rules	29	98	150	128	4	4
% of total	5,3%	18%	27,5%	23,5%	0,7%	0,7%
Method:	CTH+VA	SP+VA	WO+CTH+VA	Sets + VA	NR	TOTAL
Number of rules	94	28	2	2	6	545
% of total	17,2%	5,1%	0,4%	0,4%	1,1%	100%
<b>Key:</b> WO=wholly obtained CTH=change in tariff heading SP=specific processing						
NR=no rule (manufacture from any heading)						

*Source: Naumann (2005).*

Up until 2005, the EU was engaged in approximately 40 RTAs.<sup>299</sup> It applied different single lists of PSRoO in the mentioned agreements.

Pursuant to the previous figure, the number of PSRoO in the single lists applied by the EU was 545. Moreover, the EU applies a mixture of the three main methods in determining origin.<sup>300</sup>

The EC in one of its Green Papers reflects the EU efforts to harmonize its preferential RoO, in which the VA test is implemented as the main criterion for determining origin.<sup>301</sup>

If the EU continues applying its same numerator calculations and denominator with the imposition of a reasonable percentage of the import VC requirement, it will not find problems applying the VC test as the main criterion in determining the origin of the product. But why applying it as the main criterion without following the one defined by the WTO efforts of harmonizing non-preferential RoO (i.e., the CTC)? “Whichever approach is preferred, CTH or value-added, it could be preferred for both preferential and

<sup>299</sup> European Commission, Customs: Strategy for Simplified Rules of Origin – Frequently Asked Questions 1 (MEMO/05/95), <http://europa.eu/rapid/pressReleasesAction.do?reference=MEMO/05/95&format=HTML&aged=0&language=en&guiLanguage=en>.

<sup>300</sup> European Commission, *Justification of the Choice of a Value Added Method for the Determination of the Origin of Processed Products 3* (Working Paper: TAXUD/1121/05, Apr. 20, 2005).

<sup>301</sup> *The Rules of Origin in Preferential Trade Arrangements – Orientations for the Future*, at 4-5, 9-10, COM (2005) 100 final (Mar. 16, 2005), available at <http://www.eudelbangladesh.org/en/whatsnew/EN%20100%20-%20original.pdf>.

non-preferential RoOs.”<sup>302</sup> The EU declared that its preferential RoO cannot be based on the same WTO efforts of harmonizing non-preferential RoO because they are connected with the EU’s “external policies and negotiations.” However, part one and two of this paper reflect the will of the EU to breach some WTO principles by the application of protectionist, trade-diverting RoO in some of its preferential trade regimes. A curious observer may wonder whether this has anything to do with external EU policies and negotiations.

“The aim of science is always to reduce complexity to simplicity.”<sup>303</sup> Thus, applying the same criterion when determining origin, for preferential and non-preferential purposes, would facilitate trade for traders. Otherwise, they will be lost due to the application of different RoO. For this reason, the EU efforts to harmonize preferential RoO, while being given respect and deference, should be done pursuant to the non-preferential RoO harmonization efforts promoted by the WTO.

## 2. Harmonizing Preferential RoO? How?

Harmonized non-preferential RoO would lead toward harmonized preferential RoO because they would supply the preferential RoO with a fine pattern to be based on and consequently harmonized. That is why harmonizing preferential RoO, if attempted, should be based on the substantial transformation norm in which undergoing the minimum CTC, if not supplemented by the VC and/or the specific manufacturing operation tests, should grant origin for the non-wholly obtained good. Besides, when it comes to the application of the VC test as a supplementary criterion of origin designation, the import VC requirement of a tolerant percentage should be applied and the calculation of such percentage should be achieved by following the same EC’s standards used in calculating it.<sup>304</sup>

It is to be noted that RTAs all over the world have certain things in common concerning their RoO. Consequently, harmonizing such commonalities would be an easy task to accomplish. On the other hand, there are differences that exist between RTAs RoO, therefore requiring cooperation between the WTO member states in order to harmonize them.

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<sup>302</sup> John Barceló III, *Harmonizing Preferential Rules of Origin in the WTO System* 30 (Cornell Law School Legal Studies Research Paper No. 72, Dec. 2006).

<sup>303</sup> William James, *The Stream of Thought*, 1 THE PRINCIPLES OF PSYCHOLOGY, ch. IX (1890), available at <http://psychclassics.asu.edu/James/Principles/prin9.htm>.

<sup>304</sup> William E. James, *Rules of Origin in Emerging Asia-Pacific Preferential Trade Agreements: Will PTAs Promote Trade and Development?*, in ESCAP, TRADE FACILITATION BEYOND THE MULTILATERAL TRADE NEGOTIATIONS: REGIONAL PRACTICES, CUSTOMS VALUATION AND OTHER EMERGING ISSUES, A STUDY BY THE ASIA PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE 137-162 (2007), available at <http://www.unescap.org/tid/artnet/pub/tipub2466.pdf>.

### a. *Commonalities*

Most RTA's RoO have certain factors in common. Consequently, any efforts to harmonize preferential RoO would not find a problem harmonizing those factors. The common factors are:

- (a) General definitions;
- (b) List of wholly obtained or produced goods;
- (c) Insufficient or minimal operations or processes that do not confer origin;
- (d) Neutral elements;
- (e) Consignment criteria;
- (f) Certificate of origin;
- (g) Denial of preferential tariff treatment;
- (h) Claim for preferential tariff treatment;
- (i) Administrative arrangements relating to issuance and verification of certificate of origin.<sup>305</sup>

### b. *Differences*

The factors RTAs RoO do not, in most cases, have in common are: (1) the basic required origin method to be applied under the last substantial transformation norm; (2) the calculation of the numerator and using the denominator; (3) PSRoO; and (4) cumulation rules. Points (1) and (2) can be easily solved, if all of the arguments indicated in this part so far are taken into account. Accordingly, origin would be determined pursuant to the substantial transformation norm at which undergoing the minimum CTC would confer origin, for the non-wholly obtained product, and could be supplemented, when needed, by the application of the VC and/or the specific manufacturing operation tests. Besides, when it comes to the application of the VC test, the import VC requirement of a tolerant percentage would be applied and calculating such percentage would be achieved by following the same EC's standards used in calculating it.

#### i. *PSRoO*

Because many outstanding issues surrounding PSRoO are obstructing the WCO from completing the harmonization process of non-preferential RoO; PSRoO should not be included when harmonizing preferential RoO.

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<sup>305</sup> Ratna, *supra* note 279, at 87.

Otherwise, such harmonization would take many years to be accomplished, which similarly occurred with the harmonization process of non-preferential RoO. For this reason, I declare that I completely agree with Ratna when he said:

On the services, one can learn from the WTO Harmonization Work Programme. In the context of RTAs, it would be desirable to keep the rules of origin simple and transparent, and preferably without any product-specific rules. Thus, it would be preferable to follow a single set of general rules as qualifying criteria for the not-wholly obtained or produced goods.<sup>306</sup>

It is better and easier to comply with a general rule that clarifies the main criterion to determine the origin of the product under the last substantial norm rather than complying with a list of PSRoO that contains multiple rules applied to a variety of products. With the non-containment of PSRoO in RTAs, RoO would be unambiguous, uncomplicated, flexible, and clear for the public, traders, and producers.

#### ii. *Cumulation Rules: The Baits:*

It is known that the application of stringent RoO encourages regional trade area finished goods producers to source intermediate goods from inside of the RTA. However, with cumulation rules, finished goods producers would be induced more to source from inside of the RTA leading to a case of trade diversion if the regional trade area intermediate goods are less efficient than those of outside suppliers.

Imagine the case where stringent RoO are imposed in a RTA with a bilateral cumulation rule that preserves the origin of a finished product when produced using intermediate inputs sourced from a certain partner country in the regional trade area, taking into consideration that the inputs of the partner country are less efficient than an outside source of supply. Consequently, sourcing intermediate goods from the inefficient suppliers will take place within the regional trade area to take advantage of the cumulation rule and thus comply with the stringent RTA RoO leading to a case of trade diversion. Hence, cumulation rules were used in the previous mentioned example as bait that aims at diverting trade to the inefficient supplier of the regional trade area. As a result, cumulation rules act in many cases as protectionist, trade-diverting tools since they could protect inefficient suppliers inside of a regional trade area by diverting trade to them.

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<sup>306</sup> *Id.* at 88.

Barceló promoted similar arguments regarding cumulation rules as trade hindrances.<sup>307</sup> He stated that their role becomes more active the more stringent RoO are in a RTA.<sup>308</sup> Furthermore, Barceló mentions that cumulation rules violate the principles of article XXIV (4) of the GATT since they act as obstacles to the trade of outside suppliers with the regional trade area.<sup>309</sup> It is worth mentioning that the arguments stated at the beginning of part two of this note are similar to Barceló's arguments because, if the imposition of trade-diverting RoO violates the principles of article XXIV (4) of the GATT, then the imposition of cumulation rules also violates those principles since such rules are trade-diverting in most cases, i.e. diverting trade to inefficient suppliers of a regional trade area.<sup>310</sup>

Inefficient intermediate goods producers usually lobby for the application of cumulation rules in RTAs to serve as bait for internal finished goods producers. Once the latter fall into that trap of costly sourcing from within the regional trade area to take advantage of the cumulation rules, trade diversion takes place from efficient outside suppliers to inefficient internal ones.

*C. Suggestions Should Be Taken Into Consideration When Harmonizing Preferential RoO and Until Harmonizing the Non-preferential Ones*

By following all of the previously mentioned arguments of this part, efforts to harmonize preferential and non-preferential RoO would result in success to a considerable extent. However, there are other points should be taken into account concerning the harmonization of both preferential and non-preferential RoO.

Tolerance rules are contrary to cumulation ones because they allow sourcing a fixed magnitude of inputs from anywhere in the world without affecting the origin of the final product leading to no trade diversion.<sup>311</sup> That is why increasing the scope of applying tolerance rules would facilitate trade and needs thus to be taken into account when harmonizing preferential RoO. In addition, duty drawback and deferral rules facilitate trade for traders, but must be appropriately applied. For instance, David Gantz declared that it is "evident that the lack of duty drawback treatment could be a powerful incentive for [Mexico] to seek alternative sources of parts in the future from North American rather than third country sources... This *could result in a significant diversion of trade from third countries* (e.g., Korea, Taiwan, Japan,

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<sup>307</sup> Barceló, *supra* note 303, at 19-20.

<sup>308</sup> *Id.* at 19.

<sup>309</sup> *Id.* at 26 (referencing GATT).

<sup>310</sup> *Id.* at 25-26.

<sup>311</sup> *Id.* at 34.

and India) to regional suppliers.”<sup>312</sup> As a first step, the issue of harmonizing preferential RoO should be discussed at the World Economic Forum in Davos at the coming annual meeting.<sup>313</sup> By exchanging ideas there and by considering all of the previous steps on how to harmonize preferential RoO and how to complete the harmonization process of non-preferential ones, achieving a new record in the history of trade could come into existence. Moreover, the interests of developing countries should be taken into consideration when harmonizing either non-preferential or preferential RoO. Besides, developing countries should know that countries with big markets like the U.S. and the EU usually request their industries to present proposals concerning the harmonization process of non-preferential RoO, which might lead to some protectionist implementations. Consequently, this could happen when harmonizing preferential RoO. That is why developing countries should be aware of the mentioned because there will be no turning back once both of the latter types of rules are harmonized.<sup>314</sup>

## V. CONCLUSION

Although RoO are of great importance to international trade, they could act as international trade hindrances when used as protectionist apparatuses, when used to divert trade and when their variation becomes a nightmare for traders and producers.

By solving the outstanding issues and by applying the same criteria adopted by the WTO in its harmonization efforts of non-preferential RoO to harmonize preferential RoO without including any PSRoO or cumulation rules, RoO would be used for the uses they are designed for and without distorting trade, taking into account that trade currently is needed to be facilitated to overcome the current global economic crisis. An important issue

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<sup>312</sup> William A. Hagedorn, FTAA-Committee of Government Representatives on the Participation of Civil Society, Cover Sheet for Open Invitation Contributions, NAFTA's Implications for the Free Trade Area of the Americas in regard to Trade, Labor and Duty Drawback (June 10, 2002), *available at* [http://www.ftaa-alca.org/spcomm/soc/Contributions/Quito/cscv39\\_e.asp](http://www.ftaa-alca.org/spcomm/soc/Contributions/Quito/cscv39_e.asp).

<sup>313</sup> See World Economic Forum, <http://www.weforum.org/en/index.htm> (last visited Mar. 25, 2009).

<sup>314</sup> Vermulst, *supra* note 263, at 477. Regarding the harmonization of non-preferential RoO, Vermulst stated that, “It is important for developing/low-cost countries to realize before the negotiations in the CCC start that both tests have a great potential for protectionist applications and that major trading units such as the United States, the European Community and Japan are in the process of preparing for the negotiations; they have, for example, already asked domestic industries for their recommendations on the contents of possible harmonization rules. Developing/low-cost countries should prepare for the harmonization negotiations well in advance not to be presented with *faits accomplis* in the negotiating process.” *Id.*

that also should be kept in mind is that about 30 countries are not WTO member states. An effective harmonization of origin rules would require the compliance of all countries with the rules and hence the mentioned 30 countries will change their status from observers to members.

Harmonizing non-preferential and preferential RoO would confront the popularly termed “Spaghetti Bowl” incident, provide a clear definition for what constitutes a last substantial transformation, lead to a transparent, unbiased and proportional application of preferential RoO in preferential trade regimes, prevent using them as protectionist, trade-diverting, allow for a globalized system of production, not allow RoO to be regarded as a nightmare by traders, and not make them act AS INTERNATIONAL TRADE HINDERANCES.